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Part II

National Credit Union Administration

12 CFR Parts 703 and 704

**Investment and Deposit Activities;
Corporate Credit Unions; Proposed Rule**

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 703 and 704

Investment and Deposit Activities; Corporate Credit Unions

AGENCY: National Credit Union Administration (NCUA).

ACTION: Proposed rule.

SUMMARY: NCUA is issuing proposed revisions to the rule governing corporate credit unions (corporates). The major revisions to the rule are in the areas of capital, credit concentration limits and services. The proposed amendments enable corporates to remain competitive in the marketplace while retaining NCUA's historic focus on the safety and soundness of the corporate credit union system. The major changes to these areas necessitate some substantive changes to other provisions of the rule. Several other minor revisions are generally either a clarification or a modernization of the existing rule.

DATES: Comments must be received on or before August 30, 2002.

ADDRESSES: Direct comments to Becky Baker, Secretary of the Board. Mail or hand-deliver comments to: National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428. Fax comments to (703) 518-6319. E-mail comments to regcomments@ncua.gov. Please send comments by one method only.

FOR FURTHER INFORMATION CONTACT: Kent Buckham, Director, Office of Corporate Credit Unions, 1775 Duke Street, Alexandria, Virginia 22314-3428 or telephone (703) 518-6640; or Mary Rupp, Staff Attorney, Office of General Counsel, at the above address or telephone (703) 518-6540.

SUPPLEMENTARY INFORMATION:

A. Background

On July 28, 1999, and November 22, 2000, NCUA issued advance notices of proposed rulemaking (ANPRs). 64 FR 40787, July 28, 1999; 65 FR 70319, November 22, 2000. Based on the comments received in response to the ANPRs, the Board issued a proposed rule. 66 FR 48742, September 21, 2001. The Board received 51 comments on the proposal, 28 from corporate credit unions, nine from natural person credit unions, four from credit union trade associations, one from a bank trade association, ten from state credit union leagues and three from miscellaneous sources. The majority of the commenters commended NCUA on the process leading up to the proposed rule. They expressed appreciation for NCUA's

responsiveness to the comments on the ANPRs and the continuous dialogue NCUA has engaged in with the corporate community.

In response to the comments received, particularly in the area of capital, the Board is issuing a revised proposed rule for another round of public comment. The comments to the initial proposed rule have greatly assisted the Board in drafting the revised proposed rule and will be discussed in the relevant section of the section-by-section analysis.

B. Section-by-Section Analysis

Natural Person Credit Union Investments Section 703.100

The Board proposed increasing the limit on a natural person credit union's aggregate purchase of paid-in capital (PIC) and membership capital (MC) in one corporate to 2 percent of the credit union's assets measured at the time of purchase. The Board also proposed limiting a credit union's aggregate purchase of PIC and MC in all corporates to 4 percent.

Twenty-five commenters supported the proposal. Two commenters opposed the proposal. Those who supported the proposal indicated the ability of a natural person credit union to acquire a higher level of capital in a corporate will bring about the positive result of further capital redistribution in the credit union system. They indicated it would introduce a degree of moderation in the amount of capital a credit union could potentially invest in the corporate network. One commenter, a natural person credit union, opposed the proposal as being too restrictive because it limits credit unions' options. One commenter, a bank trade association, opposed the proposal as too permissive, contending it doubles the risk exposure a natural person credit union could have in a single corporate credit union.

Additionally, fifteen commenters suggested a revision to the proposed wording. The proposal stated the percentage is based on "the credit union's assets measured at the time of purchase." *Id.* at 48755. The commenters recommended changing "at the time of purchase" to "at the time of investment or adjustment." This would take into account the adjusted balance feature of most existing MC accounts. One commenter suggested the limit in one corporate and the aggregate limit in all corporates be set at 25 percent and 50 percent respectively of a credit union's net worth, rather than as a percentage of assets.

The revised proposed rule retains the increased investment limits in the proposed rule. Based on the comments,

the Board has made some minor wording revisions. The term "aggregate purchase" in the proposal has been revised to "aggregate amount" and the term "time of purchase" in the proposal has been revised to "time of investment or adjustment."

Definitions Section 704.2

Daily Average Net Assets (DANA)

Although not specifically addressed in the proposed rule, seventeen commenters requested that the Board exclude future dated ACH items and uncollected cash letters that are perfectly matched on both the asset and liability sides of the balance sheet from the definition of DANA. The issue is whether such transactions should be recorded on their settlement date (the date the funds are posted) or on the advice date (the date the corporate receives an advice indicating the funds will be posted on a specific future date).

The Office of Corporate Credit Unions (OCCU) issued guidance in 2000 to all corporates stating, "[i]n order to provide for a consistent approach to reporting corporate financial information, we expect all corporates to record future-dated ACH transactions as assets and liabilities on their financial statements for both regulatory and 5310 (Corporate Credit Union Call Report) reporting purposes. However, other external and internal financial statements can continue to be prepared based on the advice of your CPA." Corporate Credit Union Guidance Letter No. 2000-03, August 30, 2000. This guidance was provided because corporates were using different reporting practices and there was a lack of definitive guidance on the issue under Generally Accepted Accounting Principles (GAAP).

The commenters stated that several corporates have obtained opinions from accounting firms indicating that accounting for such transactions as of the advice date is not in accordance with GAAP. Rather, these transactions (as well as uncollected cash letters) should be accounted for on a settlement date basis. The concern is that DANA is overstated by inclusion of these items and capital ratios are understated. Several commenters also noted that the definition of "the fair value of assets" should exclude these transactions from the Net Economic Value (NEV) definition.

The Board does not agree with the commenters that accounting for such transactions as of the advice date is inconsistent with GAAP. Rather, there is a divergence of opinion in the accounting community on this issue. In order to ensure a consistent regulatory

approach, the revised proposal does not exclude these items from the definition of DANA. Each corporate should continue to prepare its other internal and external financial statements based on the advice of its CPA.

Capital Section 704.3

Requirements for Membership Capital, Section 704.3(b)(3)

The Board proposed revising the existing amortization of MC. Currently, the regulation requires a constant monthly amortization of MC placed on notice so that the full balance is amortized by the end of the notice period. The proposal required the full amortization of MC one year before the date of maturity or one year before the end of the notice period. The proposal also revised the requirements for adjusted balance MC accounts. These revisions included limiting the frequency of adjustments to no more than once every six months and, if the adjustment measure is anything other than assets, the corporate must address the measure's permanency characteristics in the capital plan.

Fifteen commenters opposed the proposed change in the amortization of MC and one commenter supported the proposal. Those opposed stated that it fails to recognize any portion of the MC that is still available to cover losses during the last year. Further, several commenters suggested amortizing MC before the end of the notice period is contrary to GAAP. One commenter opposed the entire premise of amortizing MC stating MC that has been placed on notice should count in full as long as the full balance is available to cover losses.

A few commenters commented on changes to adjusted balance MC accounts. One commenter suggested allowing MC to flow in and out of the corporate, with the corporate setting its own minimum limit based on its capital needs. One commenter suggested allowing a corporate to base the adjustment on a member's deposits in the corporate rather than on its assets. Another commenter did not object to the proposed changes in the adjusted balance MC accounts, but suggested grandfathering existing adjusted balance MC accounts.

Several commenters took exception to the proposed wording in § 704.3(b)(3) that states, "[w]hen an MC account has been placed on notice *or* has a remaining maturity of three years * * *". (emphasis added). The commenters suggested replacing "or" with "and." The commenters stated that the corporates issue adjusted balance

accounts with no maturity. Several commenters suggested adding "less than" before "three years" to avoid the mistaken impression that a three-year notice account could arguably be deemed to require amortization before being placed on notice.

The Board remains convinced that MC placed on notice should be fully amortized one year before maturity or the end of the notice period. The Board does not believe a corporate should include capital that will be paid out in less than a year in risk capital measures. The Board is also cognizant that five-year subordinated debt allowed by other financial regulators is not counted in the last year. 12 CFR part 3, App. A, § 2(b). The Board views the change in amortization as a measure of consistency with other financial regulators.

The revised proposal retains the limitation on the frequency of adjustment for adjusted balance MC accounts to no more than once every six months. The Board desires a greater degree of permanence for MC. The Board agrees with the commenter that existing MCs should be grandfathered from the change in the frequency of adjustment since corporates have already issued disclosures to their members, which should be adhered to. However, corporates that have tied their adjustments to a measure other than assets are not grandfathered from addressing the measure's permanency in their capital plans.

The revised proposal adds the words "less than" in front of "three years" to clarify that a three-year notice account is not subject to amortization if notice has not been given. The revised proposal retains the word "or," rather than substituting the word "and" as some commenters recommended, because the regulation does allow term MC accounts.

Requirements for Paid-in Capital, Section 704.3(c)(2).

Although not proposed, based on the comments and the Board's desire to eliminate the proposed minimum RUDE ratio, the Board has revised the definition of PIC, so it is a perpetual, non-cumulative dividend account. This revision brings PIC in line with the GAAP definition of equity accounts. Existing PIC is grandfathered from this requirement but is subject to the proposed amortization schedule. Because new PIC must be perpetual, the amortization requirement only applies to grandfathered PIC.

The proposal required an amortization schedule for PIC similar to that proposed for MC, full amortization

one year before the date of maturity. Twelve commenters opposed the proposed amortization for PIC. The commenters reiterated the arguments raised in opposition to the proposed amortization of MC. One commenter supported the proposed change to the amortization schedule. The revised proposal retains the amortization requirement for grandfathered PIC. This position is consistent with that taken for MC.

Additionally, the proposal eliminated the existing limitation on PIC, which limits PIC to 100 percent of RUDE. 12 CFR 704.2. Eight commenters supported removing the limitation on PIC, and three commenters opposed it. Of those in support, one suggested that only PIC up to 150 percent of RUDE should count towards any minimum regulatory capital ratio, but that all PIC should count towards a total capital ratio. One commenter opposed to eliminating the PIC limitation suggested limiting the aggregate amount of MC and PIC that counts towards a total capital requirement to 100 percent of RUDE. The Board agrees with the majority of commenters and has retained the deletion in the revised proposed rule.

Finally, the Board proposed eliminating the requirement in the current regulation that nonmember PIC requires NCUA Board approval. The proposal required Board approval if the terms and conditions of the nonmember PIC differed from member PIC. Because the revised proposed rule requires all PIC to be GAAP qualifying, the requirement for Board approval if the terms and conditions are different for nonmember PIC is deleted in the revised proposed rule.

Minimum RUDE Ratio Requirement, Section 704.3(e)

The Board proposed a minimum RUDE to moving DANA ratio of 2 percent. In addition, the proposal eliminated the reserve transfer requirements because it is unnecessary if all corporates must maintain a minimum RUDE ratio of 2 percent.

Forty-six commenters objected to a minimum RUDE ratio. Two commenters, a bank trade association and an individual, supported the proposal. Many commenters indicated this requirement was the one they most vehemently opposed.

Twenty commenters recommended the adoption of a credit-risk weighted capital requirement in lieu of a minimum RUDE ratio. Three commenters included with their comments draft credit-risk weighted guidelines for corporates. Twenty-five commenters recommended the adoption

of a "core capital ratio" requirement alone or in conjunction with a credit-risk weighted capital requirement. The core capital ratio would include RUDE and PIC, with a few commenters indicating only a portion of PIC should qualify. Several commenters suggested there is no need for a minimum RUDE ratio since NCUA has the authority to supervise and ensure adequate capital in corporates through the requirement that corporates prepare a capital plan.

Nearly all of those who objected to the minimum RUDE ratio indicated concern that the requirement would threaten the very purpose for which corporates exist. Commenters noted that, in their roles as the provider and absorber of credit union liquidity, corporates must be able to grow and contract in a prompt and fluid manner. The imposition of a mandatory RUDE ratio would force corporates to turn away credit union deposits. They noted that, not only would this affect the role of corporates in the credit union system, but it may increase risk to credit unions that seek other means for depositing or investing their excess liquidity. Commenters noted that corporates in 2000 and 2001 successfully handled a period of unprecedented liquidity demand followed by a period of unprecedented excess liquidity in the credit union system. Many commenters expressed concern that the proposed capital requirements will introduce a new factor, which will negatively affect what risk managers may allow on their balance sheets.

Commenters noted that corporates have consistently increased RUDE over the years. In fact, RUDE has grown at a higher rate than the minimum requirements under the regulation. Commenters suggested the proposal would force corporates to focus on the goal of building RUDE to the detriment of the products and services the corporates offer the credit union system. Further, commenters asserted that lessening the regulatory value of PIC may lead to an outflow of capital from the corporate system. Corporates trying to maximize earnings to build RUDE may call their PIC to reduce expenses. Commenters suggested it would take years to build the RUDE just to replace the called PIC. The commenters stated that NCUA's concern that corporates would not continue to strive to build RUDE, or would arbitrarily decide to return PIC to members, is baseless and not supported by past performance. Further, several commenters stated that RUDE levels in corporate credit unions are already adequate, based on the risks corporates take. Several commenters noted the 2 percent requirement appears

arbitrary and NCUA has offered no findings to support that it is an appropriate level.

Many commenters noted that, while the proposed preamble indicates a goal of instituting a RUDE ratio is to reach a level of capital comparability with other financial intuitions, the proposal is inconsistent with the capital structure of other financial depository institutions. The commenters noted some of the other financial regulators include common stock and noncumulative perpetual preferred stock in the determination of their core capital requirements. As such, the commenters noted that NCUA's core capital requirements for corporates should recognize PIC.

In keeping with the concept of comparable capital measures with other federally-insured financial institutions, a number of commenters recommended the adoption of a credit-risk weighted capital structure. Many commenters suggested that the new Basel Capital Accord Proposal establishes a framework intended to more closely align regulatory capital requirements with underlying risk. The proposal noted that the Board was not considering a credit-risk weighted requirement due to the added burden on corporate credit unions. Several commenters suggested the proposed RUDE ratio was more burdensome to corporates than the adoption of a credit-risk weighted capital structure. Finally, several commenters suggested that, if the Board does not establish a credit-risk weighted structure at this time, it should create a working group to study the issue and make a recommendation to the Board within the next two years.

In addition to the suggestion of a credit-risk weighted approach to capital, several commenters suggested the use of a core capital requirement. Some commenters suggested the use of core capital as a single measure while others recommended its use in conjunction with a credit-risk weighted capital measure. As noted above, several commenters made reference to the recognition of common stock and noncumulative perpetual preferred stock in the determination of core capital in other financial institutions. The commenters noted that MC and PIC are available to absorb losses before any impact on the National Credit Union Share Insurance Fund (NCUSIF). They contend PIC is a long-term, stable component of capital because of its regulatory requirements. As such, commenters believe NCUA's core capital calculation should include PIC. Some commenters recommended that all PIC be counted as core capital, while

others suggested a percentage limitation. Others suggested that only PIC that qualifies under GAAP should be included in core capital.

Several commenters noted that PIC was introduced during the last regulatory revision. Many corporates solicited their members and were able to raise significant amounts of PIC. These commenters noted their concern for the reputation of the individual corporates, and the corporate system as a whole, if member credit unions are now told the PIC they committed to the corporate is not considered "real" capital. Further, many noted that the influx of funds into a corporate might not necessarily translate into an increase in risk. Under the proposal, the mere inflow of excess liquidity could trigger the need for a capital restoration plan. It is possible that a regulatory requirement could affect the opinion of the corporate's auditors or the rating issued by a nationally recognized statistical rating organization. The commenters noted the ripple effect of these occurrences on the reputation, as well as the safety and soundness, of the corporate could be severe, while no significant increase in risk has actually occurred.

As noted above, some commenters stated the existing regulations provide NCUA with adequate authority to ensure the capital strength in the corporate system. Section 704.3(a) requires corporates to develop a written capital plan. The regulation requires the corporate to develop and implement short and long term capital goals, objectives, and strategies that provide for building capital consistent with regulatory requirements, and capital sufficient to support a corporate's current and projected business risks. The plans are subject to review by NCUA through the supervision process. The commenters believe this requirement provides NCUA the ongoing opportunity to monitor and exert regulatory oversight over a corporate's capital intentions.

Only one commenter, a bank trade association, objected to the elimination of the reserve transfer requirement.

The Board believes that a minimum RUDE ratio may have the unintended consequence of limiting the traditional role of corporates as depositors of excess liquidity for natural person credit unions. As such, the minimum RUDE ratio requirement has been eliminated from the revised proposal.

The Board remains convinced of the need for corporates to continue to maintain an adequate level of retained earnings. To that end, the revised proposal adopts several of the commenters' suggestions, in addition to

incorporating existing requirements in § 704.3.

Rather than the proposed minimum 2 percent RUDE ratio requirement, the revised proposal provides a mechanism for increasing retained earnings to 2 percent on an ongoing basis. The earnings retention requirement in § 704.3(i) includes features of the existing reserve transfer requirement, in addition to a core capital measurement.

As the current regulation does not define retained earnings, the revised proposal adds a definition. The definition specifically excludes GAAP recognized "other comprehensive income accounts" such as unrealized gains and losses on available for sale securities. These accounts may distort a corporate's capital position; so the Board is excluding these accounts from the definition. Additionally, the definition excludes the allowance for loan and lease losses. Although the allowance for loan and lease losses is nonexistent in most corporate credit unions, it may become more common in corporates that engage in loan participations with their members under the proposed Part V expanded authority. Since the allowance for loan and lease losses is funded to the amount of anticipated losses, the Board contends that amount should not be recognized for the purpose of determining retained earnings.

Numerous commenters recommended, in lieu of a minimum RUDE ratio, retaining the reserve transfer requirement in the current regulation as a means of building capital. The Board agrees with the need to increase capital but believes the existing reserve transfer requirement may not result in the accumulation of retained earnings. Under the current regulation, a corporate can meet its reserve transfer requirement without an overall increase to retained earnings. Therefore, the revised proposal establishes an earnings retention requirement of 10 or 15 basis points per annum based upon the corporate's retained earnings and core capital ratio. The earnings retention requirement is established at 10 and 15 basis points to provide for the building of retained earnings while also recognizing the value of PIC.

Several commenters also recommended adopting a core capital measurement to recognize the value of PIC. In response, the Board has re-titled the existing definition of "reserve ratio," which includes retained earnings and PIC, as "core capital ratio." The core capital ratio, in conjunction with the retained earnings ratio, is used to determine the earnings retention factor.

A number of commenters noted that PIC, a long-term capital account, is available to absorb losses. The Board agrees with the need to recognize the value of PIC in the capital structure of corporates; however, the Board also notes that the major disadvantage of using PIC rather than retained earnings to absorb losses is the potential for erosion of member confidence in the viability of the corporate. The Board is establishing an earnings retention factor to serve the dual purpose of building retained earnings while also providing value to PIC. As such, a corporate with a core capital ratio greater than 3 percent will have a lower earnings retention factor than a corporate with a core capital ratio less than 3 percent.

The Board notes the earnings retention requirement eases the regulatory burden on corporates from that in the proposal. Under the proposed regulation, a RUDE restoration plan was required if the RUDE ratio fell below 2 percent. Rather than requiring a corporate to submit a RUDE restoration plan if the retained earnings ratio falls below 2 percent, the revised proposed rule establishes a specific restoration plan for retained earnings.

The Board is cognizant that circumstances may arise where corporate management will have to make operational decisions that are in the best interest of the corporate, but may also result in an inability to meet the earnings retention requirement. To provide flexibility, the Board permits corporates to meet earnings retention requirements on a rolling three-month average. The regulation also allows a corporate to pay dividends without prior approval if its retained earnings ratio falls below 2 percent, if the retained earnings ratio was already below 2 percent but the corporate has an increase in retained earnings for the current measurement period, or if the corporate experiences a loss on the sale of investments. In addition, the regulation provides the OCCU Director the authority to approve a lower earnings retention amount to avoid a significant adverse impact on the corporate.

The Board believes it is imperative to the long-term safety and soundness of the corporate credit union system that a regulatory framework exist to facilitate the ongoing accumulation of retained earnings. An earnings retention requirement will provide certainty to corporates as to regulatory requirements, while permitting corporates the flexibility to continue the vital role they play in assisting natural person credit unions in serving their members.

The Board is steadfast in its contention that a credit-risk weighted capital approach is not the best measure for risk in corporates. Further, there exists a divergence of opinion in the financial community as to the validity of some of the risk weights assigned to the various risk categories.

Several outside studies of the corporate credit union system have been critical of using credit risk as a primary means of measuring overall risk in corporates. The report entitled "Corporate Credit Union Network Investments: Risks and Risk Management," issued in 1994 by a committee headed by Dr. Harold Black, indicated many corporates traditionally take very little credit risk, but instead assume a higher level of interest rate risk. The General Accounting Office (GAO) reports of 1991 and 1994 both noted that an over reliance on credit-risk weighted capital failed to fully capture other risks (market, liquidity, and operational) in corporate credit unions. A December 1997 study by the Department of the Treasury specifically stated that a credit-risk weighted capital approach "is inappropriate given that corporate credit unions generally have little credit risk."

Capital Directive, Section 704.3(h)(i)

The proposal made the capital restoration requirement in current § 704.3(f) applicable to a corporate failing to meet the minimum RUDE ratio. Since the revised proposal eliminates a RUDE ratio requirement, this issue is moot and there are no changes to the current rule.

Eight commenters indicated there should be an appeal process in this section, similar to the procedures for prompt corrective action (PCA). 12 CFR part 702. Several commenters suggested that the public disclosure of the existence of a capital directive or capital restoration plan in a corporate credit union could be disastrous to the reputation of the institution. One commenter opposed the current inclusion of any kind of capital restoration plan in the regulation.

Although the revised proposal does not add a specific appeal process to this section, the regulation continues to require NCUA Board approval of capital directives.

Board Responsibilities, Section 704.4

The proposed rule changed the term "operating policies" to "policies" throughout this section and changed the title of subsection (c) to "Other requirements." The commenters supported this change and it has been retained as proposed.

Investments, Section 704.5

The proposed rule deleted several investment-related definitions no longer used in the regulation and amended the definitions of: Asset-backed security (ABS), Collateralized mortgage obligation (CMO), Forward settlement, Quoted market price, Mortgage related security, Regular-way settlement, Repurchase transaction, and Residual interest. The few comments received on these definitions supported the proposal, and they have been deleted or amended as proposed. As discussed below, the revised proposed rule includes a new definition of a limited liquidity investment.

Policies, Section 704.5(a).

The proposed rule combined the policy requirements in this section and deleted "if any" from § 704.5(a)(1) to clarify a corporate must have "appropriate tests and criteria" to evaluate investments it makes on an ongoing basis, as well as new investments. No comments were received on these provisions, and they have been retained as proposed.

Section 704.5(a)(2). The proposed rule deleted the requirement that the investment policy address the marketing of liabilities to its members. No comments were received on this provision, and it is deleted in the revised proposed rule.

The proposed rule added a requirement for a corporate to establish appropriate aggregate limits on limited liquidity investments, including private placements and funding agreements. A number of commenters observed many privately placed securities have active quoted markets or readily obtainable market quotes, with liquidity comparable to publicly registered securities. In response to those comments, the Board notes other private placements do not have readily obtainable market quotes. A corporate would have difficulty selling such investments with reasonable promptness at a price that corresponds reasonably to fair value. The Board also is concerned if there is only one active market purchaser for a private placement or a funding agreement. The revised proposed rule omits the examples of limited liquidity investments, defines a limited liquidity investment to mean a private placement or a funding agreement, requires a corporate to specify concentration limits in relation to capital and requires the investment policy to address reasonable and supportable concentration limits for limited liquidity investments. By reasonable, the Board means

concentration limits should be economically reasonable. By supportable, the Board means the investment policy should address the prepurchase analysis a corporate should undertake before making a limited liquidity investment. For example, the investment policy may require a prepurchase analysis to include estimates of bid-asked spreads and, also, an estimate of the time necessary to sell a limited liquidity investment.

Several commenters suggested addressing concentration limits for limited liquidity investments in the contingency funding plan required in § 704.9. The Board notes the concentration limit requirement emphasizes the need to address risk tolerances for portfolios of limited liquidity investments. Articulated risk tolerances for portfolios with limited liquidity investments are separate and distinct from contingency funding plans. Contingency funding plans address successively deteriorating liquidity scenarios and focus on the most liquid sources of funds. Concentration limits for limited liquidity investments focus on investments with relatively lower levels of liquidity.

Authorized Activities, Section 704.5(c)(5)

The proposed rule clarified an ABS must be domestically issued. Several commenters supported the proposal, agreeing that foreign exposure in a domestically-issued ABS should be handled as a supervisory matter. This section is retained as proposed.

Section 704.5(c)(6). The proposal deleted this section, which provided specific authorization for CMOs. Two commenters supported the deletion, since these investments are still authorized under § 704.5(c)(1) and (5). This provision is deleted in the revised proposal.

Repurchase Agreements, Section 704.5(d)

The proposed rule made several changes to the requirements for repurchase agreements, generally to conform to current market practices. Many commenters objected to the change requiring a corporate to obtain a perfected first priority security interest in repurchase securities. The commenters noted a perfected first priority security interest is inconsistent with standard market practices for repurchase transactions. The Board agrees and that portion of the proposed rule is deleted. The commenters did not object to the other changes, and they are retained in the revised proposed rule.

Securities Lending, Section 704.5(e)

The proposed rule made several nonsubstantive changes to the requirements for securities lending transactions to clarify the rule and conform it more closely to current market practices. There were no comments on the proposed changes; however, ten commenters viewed the existing requirement for a perfected first priority security interest as inconsistent with standard market practice for securities lending agreements. The Board agrees with the commenters and has removed the word "perfected" but will continue to require a first priority security interest through possession or control of the collateral. Often, under state law, possession or control constitutes a "perfected" security interest. In addition, the Board has clarified in the revised proposal that ownership is an appropriate substitute for possession and control.

Investment Companies, Section 704.5(f)

The proposed rule clarified the prospectus is the document restricting the portfolio of an investment company. A few commenters supported this clarification, and it has been retained as proposed.

Prohibitions, Section 704.5(h)

The proposed rule prohibited trading securities. One commenter supported this prohibition. A few commenters opposed the prohibition, but supported the existing prohibitions on pair-off transactions, when-issued trading, adjusted trading, and short sales. The revised proposal, like the current rule, permits trading securities but requires transactions to be accounted for on a trade date basis and, in addition, no longer prohibits engaging in pair-off transactions and when-issued trading. The Board agrees with the commenters that concerns with these investments should be handled as a supervisory matter. The Board notes corporates engaging in trading securities must have sufficient resources, knowledge, systems and procedures to handle the risks. The revised proposed rule retains the prohibitions on engaging in adjusted trading and short sales.

The proposed rule prohibited investments in residual interests in ABS, deleted the prohibition on commercial mortgage related securities, and moved the prohibition on the purchase of mortgage servicing rights from the investments section to the permissible services section. A few commenters supported these proposed changes, and these provisions are unchanged in the revised proposed rule.

Credit Risk Management, Section 704.6

The proposed rule defined “obligor” to mean the primary party obligated to repay an investment and excluded from the definition the originator of receivables underlying an asset-backed security, the servicer of such receivables, or an insurer of an investment. A few commenters supported this definition, and it is retained as proposed. One commenter proposed including any party obligated to make repayment, including secondary parties such as an insurer, in the definition of obligor and, therefore, within the rule’s credit concentration limit. The Board declines to impose regulatory credit risk concentration limits on insurers of investments, but notes § 704.6(a)(4) requires a corporate’s credit risk management policy to address concentrations of credit risk exposure, which would include an insurer of an investment.

Although not previously proposed, the revised proposal deletes the definitions of “short-term investment” and “long-term investment” since they are no longer used, as explained below. The revised proposed rule also deletes the definition of “expected maturity,” since that term was only used in the definitions of these deleted terms.

Policies, Section 704.6(a)

The proposed rule amended the policy requirements to base credit limits on capital, rather than RUDE and PIC. The proposed rule deleted the requirement that the credit risk management policy address loan credit limits. The proposed rule added to the examples of concentrations of credit risk an “originator of receivables” and an “insurer.” A few commenters supported the proposal to base credit limits on capital. While one commenter opposed adding examples of credit concentration risk, the commenter suggested all types of such risk should be adequately addressed in the policy. In response, the Board notes the revised proposal’s examples of credit concentration are illustrative only. A corporate’s credit risk management policy should address all material types of concentrations of credit risk, regardless of whether included in the examples. This section is retained as proposed.

Exemption, Section 704.6(b)

The proposed rule required subordinated debt of government sponsored enterprises to meet the rule’s credit risk management requirements. The few comments received supported the proposed rule, and it is unchanged in the revised proposed rule.

Concentration Limits, Section 704.6(c)

The proposed rule set concentration limits in relation to capital. Likewise, the revised proposal establishes a general credit concentration limit of 50 percent of capital or a *de minimis* limit of \$5 million for the aggregate of all investments in any single obligor, whichever is greater.

A bank trade group that commented asserted these changes would permit larger investments by corporates. The Board notes that, based on current levels of capital, these changes have the overall effect of reducing credit concentration limits from the prior limits.

Many commenters opposed the proposed general credit concentration limit as too restrictive. Some commenters noted the proposed limit would substantially restrict investments in certain AAA rated instruments from prior levels (*e.g.*, the prior limit of 200 percent of RUDE and PIC on mortgage-backed and asset-backed securities). While observing that diversification is normally a desirable goal, a number of commenters noted the proposed limits could force increased aggregate exposure to lower quality credits. A number of these commenters suggested a general credit concentration limit of 100 percent of capital on investments rated no lower than AA–(or equivalent) or A–1 (or equivalent). A few advocated increasing the proposed general credit concentration limit to 100 percent of capital, regardless of credit rating. A number of commenters advocated a risk-based capital framework to require higher levels of capital for lower rated investments in lieu of credit concentration limits.

As the Board noted in the proposal, the 50 percent limit provides corporates with substantial flexibility compared to other depository institutions. *Id.* at 48746. The Board believes this limit is the most credit exposure a corporate should prudently take in investment-grade quality investments. The Board recognizes the corporate network has increased its due diligence capabilities. However, if the corporate network is to maintain and enhance its ability to withstand financial crises, it must exercise caution in placing membership capital at risk. Placing all capital at risk would substantially increase the likelihood of a crisis and decrease membership confidence if losses occurred.

The Board also noted in the proposed rule that adoption of a credit-risk weighted capital requirement is not warranted. *Id.* at 48743. The Board’s long-standing opinion is that such a

requirement would provide limited regulatory value where corporates are concerned. 62 FR 12929, 12931, March 19, 1997. The Board again suggests to corporates choosing voluntarily to calculate a credit-risk weighted capital ratio that they adopt the same standards used by other financial institutions.

The Board notes a credit-risk weighted capital requirement would impose a macro level restriction on aggregate credit exposure to the entire balance sheet. In contrast, the credit concentration limit in the revised proposed rule is a micro level restriction on credit exposure to a single obligor.

Section 704.6(c)(2) of the proposed rule provides exceptions to the general credit concentration rule. For repurchase and securities lending transactions, the proposed limit was 200 percent of capital. Investments in corporate CUSOs are subject to the limitations in § 704.11. Investments in wholesale corporates and aggregate investments in other corporates are exempt.

A number of commenters requested that the proposed credit concentration limit of 200 percent of capital on repurchase transactions be increased to 250 percent of capital. The commenters contended 200 percent is too restrictive in periods of large liquidity inflows. One commenter expressed general support for excepting repurchase transactions from the general credit concentration limit. In response to comments, the Board notes greater concentration limits in repurchase transactions are available to corporates meeting the infrastructure requirements of Part I or Part II expanded authorities.

One commenter supported the exception for CUSO investments. This provision is unchanged in the revised proposed rule.

A few comments supported the proposal to exempt investments in corporates from concentration limits. Two commenters thought the exemption should be limited to wholesale corporates: one noted the proposal appeared to increase systemic risk, while the other suggested adding a requirement for a corporate to obtain at least one credit rating for other corporate investments. The Board continues to believe the capital requirements for the receiving corporate will serve to limit the amount of investment any corporate may place in another corporate. In addition, the Board weighed the potential for increased systemic risk against the potential benefits of allowing additional alternatives to moving liquidity within the corporate system. Therefore, the Board believes it is appropriate to

expand the exemption to include all corporates. The Board reiterates that a corporate's credit risk management policy must address investments in corporates that are not fully insured by the NCUSIF.

Proposed § 704.6(c)(3) applied the requirements for an investment action plan in § 704.10 when a reduction in capital after the purchase of an investment resulted in a credit concentration that was higher than permitted by regulation. One commenter believes that noncompliance caused by a reduction in capital should not trigger the 30-day notification period in § 704.10. Rather, the commenter suggests calling the investment "nonconforming" rather than "failed" and allowing a 90-day period to permit a corporate to bring the investment into compliance before triggering the requirements of § 704.10. This is similar to the approach used by the Office of the Comptroller of the Currency, 23 CFR 1.8.

The Board agrees with the commenter's suggestion, and the revised proposed rule deems an investment as "nonconforming" if it fails a requirement because of a reduction in capital. A corporate credit union is required to exercise reasonable efforts to bring nonconforming investments into conformity within 90 days. Investments that remain nonconforming for 90 days are deemed to "fail" a requirement and will require compliance with the requirements in § 704.10. The Board cautions corporates to consider the permanence of capital before committing investment funds. Because corporate concentration limits provide for substantial flexibility in comparison to other depository institutions, the Board is adopting the specific time frame suggested by the commenter, rather than an open-ended time frame for nonconforming investments.

Credit Ratings, Section 704.6(d)

This section reduced the applicable credit rating to AA-(or equivalent) for a long-term investment and A-1 (or equivalent) for a short-term investment. The proposed rule applied the investment action plan requirements of § 704.10 if at least two ratings were downgraded and a corporate had relied on more than one rating to meet the minimum credit rating requirements at the time of purchase.

A number of commenters generally supported the credit rating requirements. However, most of the commenters noted the regulation's definitions of "short-term investment" and "long-term investment" can be inconsistent with the market. For

consistency, they suggested the rule reference investments with short-term or long-term ratings. The Board agrees and adopts the suggestion in the revised proposed rule.

One commenter advocated permitting investment in any investment grade instrument, particularly for repurchase transactions. The commenter noted the typical cash market practice for repurchase transactions is to require investment grade securities. In contrast, another commenter expressed caution that prudent risk management skills and infrastructure should be required to take on more credit risk. In light of the substantial flexibility already provided to corporates, the Board remains convinced a base level corporate should not be permitted to acquire more than limited credit risk exposure. Expanded authority provisions allow for a broader spectrum of credit risk, and require increased due diligence by corporates that obtain such authority.

Another commenter questioned whether "or equivalent" when referring to acceptable ratings such as "A-1 (or equivalent)" meant a rating of another NRSRO or an evaluation by credit staff at a corporate. The Board notes this continues to refer to a rating of another NRSRO, and not an evaluation by credit staff at a corporate. Because of the substantial flexibility provided to corporates in concentration limits, the Board declines to permit internal credit analysis of investments in lieu of a rating by an NRSRO. While an NRSRO rating is no substitute for due diligence, it is a useful tool for investors to evaluate credit risk. The Board also notes "or equivalent" does not refer to a rating of an issuer that is not directly applicable to the investment. For example, a corporate may not rely on a short-term issuer rating to comply with the minimum rating requirement for an investment with a long-term rating.

To avoid confusion regarding the investment watch list requirements of § 704.6(e)(1), the revised proposed rule clarifies in § 704.6(d)(4) that it is applicable only when the corporate relied upon more than one rating to meet the minimum credit rating requirements at the time of purchase. If there is a subsequent downgrade below the minimum requirement, then the investment must be placed on the investment watch list. The revised proposed rule permits a board to decide under § 704.6(e)(1) to what extent it will require management to report to the board its review of a downgrade that does not result in a rating lower than the minimum requirements of part 704. The Board notes it remains a sound business practice for a corporate to monitor the

credit quality of all investments, including reviewing any downgrades of credit ratings.

Reporting and Documentation, Section 704.6(e)

The proposed rule clarified that requirements for annual approval apply to each credit limit with each obligor or transaction counterparty. Those commenters who addressed this change supported the proposed clarification, and it is retained as proposed.

Lending, Section 704.7

Section 704.7(c)(1) and (2). Currently, the aggregate secured and unsecured loan and line of credit limits to any one member credit union are based on the higher of a percentage of capital or a percentage of RUDE and PIC. The Board proposed basing the loan limits on a percentage of capital and eliminating the option of basing them on a percentage of RUDE and PIC. Several commenters objected to eliminating this option. These commenters indicated the proposed limits were too restrictive and would not provide corporates adequate flexibility to meet member liquidity needs. The Board considered the comments and concluded that the percentages of capital in the proposed rule provide sufficient flexibility when balanced against safety and soundness concerns associated with a higher loan to one borrower ratio.

Section 704.7(c)(3). This section of the proposed rule stated the maximum aggregate amount of loans and lines of credit is limited to 15 percent of the corporate's capital plus pledged shares for members that are not credit unions. This is identical to current § 704.7(d). Several commenters indicated proposed § 704.7(c)(3) conflicts with proposed § 704.7(e)(3), which requires compliance with the aggregate limits in § 723.16 of the member business loan rule.

The Board notes that these two provisions do not conflict because § 704.7(c)(3) is the individual limit and § 704.7(e)(3) is the aggregate limit. To clarify this, the Board has placed the word "one" in front of "member" in revised proposed § 704.7(c)(3).

Currently, § 704.7(c) and (d) reference "irrevocable" loans and lines of credit. The Board proposed clarifying its intent that these sections apply to both "irrevocable" and "revocable" loans and lines of credit. No commenter objected to the proposed clarification; therefore, the Board is deleting the modifier "irrevocable" from these sections of the revised proposed rule.

Proposed § 704.7(e) attempted to clarify the applicability of the member business loan rule in part 723 to loans

granted by a corporate. Based on the comments, the Board realizes there is still some confusion and is amending the revised proposed rule to state that all loans exempt under § 723.1 are exempt from compliance with the member business loan rule.

Proposed § 704.7(e)(3) expanded the partial exemption from the member business loan rule in current § 704.7(d). The partial exemption requires compliance with the aggregate limits in § 723.16 but exempts a corporate from the other requirements in part 723. The Board proposed adding to the current, partial exemption for guaranteed loans, loans that are fully secured by U.S. Treasury or agency securities. No commenter objected and this change is retained in the revised proposed rule. The revised proposed rule also clarifies that the aggregate limits of § 723.16 are statutory, and a corporate is not exempt from these limits unless the loan is not a business loan as defined in § 723.1(b).

Section 704.7(g). The Board proposed revising the provision governing loan participations between corporates to include a requirement that a corporate execute a master participation loan agreement before the purchase or the sale of a participation loan. In conjunction with this requirement, the Board deleted the language that a participation loan agreement may be executed at any time before, during, or after the disbursement. No comments were received on this section, and this requirement is retained in the revised proposed rule.

Currently, a corporate is not permitted to participate in loans with natural person credit unions, although some corporates have obtained an NCUA Board waiver to do so. The Board proposed adding this authority as an expanded authority in Appendix B, Part V. No comments were received on the proposal to make it an expanded authority, and the Board is retaining it in the revised proposed rule.

Finally, the Board proposed reorganizing the lending section to make it easier to read. No commenter objected to the reorganization; therefore, the revised proposal incorporates the proposed changes.

Asset and Liability Management, Section 704.8

The proposed rule deleted the term “net interest income” because it is no longer used in the regulation and amended the definitions of “net economic value (NEV)” and “fair value.” NEV means the fair value of assets minus the fair value of liabilities. The amended definition excluded from

liabilities both PIC and MC, rather than excluding only PIC.

Two commenters supported the amended definition of NEV, but one noted the exclusion of MC from liabilities may be contrary to market practice because others may not recognize three-year notice accounts as capital. The Board notes debt instruments with shorter maturities are recognized for certain regulatory capital purposes in other depository institutions. 12 CFR part 3, App. B.

One commenter suggested including all off balance sheet financial derivatives in the definition of NEV. The Board does not agree and notes for purposes of NEV measurement, fair values are to be determined for all assets and liabilities that are balance sheet items under GAAP. NCUA acknowledges that GAAP does not require accounting for immaterial positions in financial derivatives on balance sheet. The Board notes corporates must have Part IV Expanded Authorities to engage in derivative transactions.

Policies, Section 704.8(a)(2)

The proposed rule eliminated the redundancies with § 704.5(a) and changed the term “current NEV” to “base case NEV” to provide uniform usage throughout the regulation. All commenters addressing this section were supportive, and the revised proposal adopts the proposed changes.

Section 704.8(a)(5). The proposed rule deleted the requirement for a policy limit on decline in net income. The few commenters on this section supported this deletion, and the revised proposed rule retains the deletion.

Section 704.8(a)(6). This section added a requirement for the asset and liability management policy to address the tests used to evaluate the impact of investments on the percentage decline in NEV, compared to the base case NEV. Many commenters opposed this requirement. Commenters noted tests are not appropriate for investments such as cash instruments, short-term investments, and pure floating-rate investments. Some noted it was impractical and untimely to run a complete NEV analysis to establish a base case at the time of each investment transaction. Others suggested reflecting the tests in operating procedures, rather than policies, and reviewing as a supervisory issue.

NCUA does not intend to require corporate policies to specify tests for investments with minimal investment rate risk. In addition, the Board would not expect tests to evaluate the impact of an investment in a wholesale

corporate credit union that is funded by a share certificate with identical characteristics. Rather, the rule requires the board to address tests, as appropriate, for investments expected to impact the percentage decline in NEV, compared to the base case NEV as most recently determined for the balance sheet. The revised proposal clarifies NCUA does not expect a corporate to run a complete NEV analysis to establish a base case at the time of each investment transaction. Indeed, NCUA notes that measuring risk is an imprecise business because of the multitude of assumptions that are required to evaluate potential outcomes. However, the revised proposed rule is intended to require each corporate to establish an ongoing process to identify, estimate, monitor and control interest rate risk between the periodic complete NEV analysis.

Penalty for Early Withdrawals, Section 704.8(c)

The proposed rule required a corporate to impose a market-based penalty for early withdrawal, if early withdrawal is permitted. The proposed rule also required the penalty to equal the estimated replacement cost of the certificate or share redeemed. This change would have prohibited a corporate from imposing a penalty in excess of the replacement cost and would have required a penalty to be reasonably related to current offering rates of that corporate.

Many commenters objected to the proposed provision, asserting that penalties should be market based, and not based on rates currently offered by a corporate. Some of these commenters observed rates offered by a corporate may reflect limited quantity “specials” or other certificate marketing programs and, therefore, not reflect market rates. One commenter suggested early withdrawal should be subject to a market gain or loss. Another commenter stated that a corporate is exposed to the asset side of the balance sheet when redeeming a liability. A commenter noted an early withdrawal penalty should be assessed using all liquidity factors including size, bid or offer spreads, certificate features, and market conditions. A number of commenters suggested that no changes to the current regulation are needed.

The Board is persuaded that no substantive change is needed to this section and has withdrawn the proposed amendments. The Board notes the current rule requires a market based penalty sufficient to cover the estimated replacement cost of the liability redeemed. The Board proposes to clarify

that this means the minimum penalty must be reasonably related to the rate that the corporate would be required to offer to attract funds for a similar term with similar characteristics. NCUA agrees the minimum penalty was not intended to cover limited offerings of liabilities with above market rates. The minimum penalty also does not reflect the value of any specific asset of the corporate. A gain does not appear consistent with the notion of a penalty for early withdrawal. In the event a member needs liquidity in advance of maturity of a share certificate bearing an above market rate, the Board suggests the corporate offer a share secured loan, as appropriate. As the commenters suggest, the Board will leave to the marketplace the determination of penalties above the minimum penalty specified in the rule.

Interest Rate Sensitivity Analysis, Section 704.8(d)

The proposal deleted the requirement to conduct net interest income simulations. Many commenters supported this elimination, and it is deleted in the revised proposed rule.

The existing rule requires a corporate to evaluate the impact of shocks in the Treasury yield curve on its NEV and NEV ratio. One commenter suggested deleting the word "Treasury," since the market has moved away from the Treasury yield curve as a benchmark. In response, the revised proposed rule omits the word "Treasury." NCUA recognizes risk management practitioners often use a yield curve based on London Interbank Offered Rates (LIBOR).

Section 704.8(d)(1)(i). The proposed rule increased from two to three percent the minimum base case NEV ratio that triggers monthly interest rate sensitivity analysis testing. A number of commenters supported this increased NEV ratio. One commenter observed it was a sound business practice to assess monthly the impact of interest rate shocks on NEV, NEV ratio, and net interest income. Another commenter suggested setting the trigger at four percent, rather than three percent, since the base case NEV ratio for most corporates will increase significantly because of the new definition of NEV. The Board believes it is a sound business practice to assess interest rate risk periodically, as appropriate, and continues to believe at least quarterly analysis is appropriate for base level corporates. The revised proposed rule is retained as proposed.

Proposed § 704.8(d)(1)(ii) limited a corporate's risk exposure to levels that do not result in any NEV ratio resulting

from the specified parallel shock tests, or a base case NEV ratio, of less than two percent, rather than one percent. Some commenters supported the two percent minimum NEV ratio. One commenter advocated establishing the minimum NEV limit under the shock scenarios at one percent, rather than two percent. The Board notes the proposed definition of NEV is intended to estimate the reserve of capital available to manage all other risks of the corporate other than the risks associated with changes in interest rates. The section is retained as proposed.

Section 704.8(d)(1)(iii). The proposal reduced the NEV decline limit for a base corporate from 18 to 10 percent. Numerous commenters opposed the proposed limit of 10 percent, since it may reduce the currently permissible amount of interest rate risk for some corporates. Many commenters requested the Board re-evaluate the limits to avoid diminishing the permitted amount of interest rate risk exposure. In contrast, one commenter suggested reducing the NEV decline limit further, to 8 percent, to maintain parity on average with the current rule, and one commenter supported the change. One commenter noted the reduction may have the unintended consequence of encouraging issuance of additional MC as a way of maintaining the dollar value of permissible at risk NEV.

Based on the comments, the Board has re-evaluated the NEV decline limit for a base corporate. The revised proposed rule establishes a limit of 15 percent. This increases the amount of interest rate risk most base corporates may undertake compared to the existing regulation. The Board is comfortable with the increased risk because the corporate system has improved its ability to measure interest rate risk since the existing regulation was adopted. NCUA recognizes that taking prudently controlled risk is necessary to obtain reasonable returns. The Board declines to impose a limit that may reduce substantially the amount of interest rate risk a base corporate may undertake. However, the Board cautions against over reliance on MC as a way of increasing the amount of interest rate risk permitted.

Section 704.8(d)(2). The proposed rule required all corporates to assess annually whether it is appropriate to conduct periodic, additional, interest rate risk tests. These additional tests formerly were triggered based on the level of unmatched embedded options. A number of commenters supported this change, and it is retained as proposed.

Regulatory Violations, and Policy Violations, section 704.8(e) and (f). No

comments were received on these sections. The proposed changes were non-substantive grammatical amendments. The revised proposal incorporates the proposed amendments and also designates the OCCU Director to respond to regulatory violations. There has been some confusion regarding when reports of violations must be made. The Board notes the 10-day time period runs from the date the corporate first produces or receives reports of its NEV. Revisions or reruns of reports do not delay the reporting requirement.

Divestiture, Section 704.10

The Board did not propose any changes to this provision, however, because of confusion concerning this provision, the Board proposes retitling it "Investment Action Plan." This change clarifies that divestiture is not the only remedy available under this section.

Corporate CUSOs, Section 704.11

The proposed rule added new due diligence requirements for corporates' loans to corporate CUSOs. These requirements were taken from the member business loan rule. All six of the commenters that commented on this issue opposed the additional requirements. Commenters suggested underwriting is a supervision issue and should be addressed as part of the examination process and not in a regulation. One of the commenters noted that this requirement may limit a corporate's desire to provide necessary liquidity to key service providers.

The Board believes these due diligence requirements are the minimum requirements necessary to insure the corporate is engaging in safe and sound lending practices. The requirements should not place a new burden on corporates because any corporate that makes a loan to a corporate CUSO should already be following these requirements.

Six commenters requested that the current 15 percent aggregate limit for investments in and loans to corporate CUSOs be increased to 30 percent and the additional 15 percent for loans that are fully secured be retained.

The Board agrees that with respect to loans to corporate CUSOs. Because of the mandatory due diligence requirements, a corporate' lending limits should be increased to 30 percent. The Board has safety and soundness concerns with increasing the investment limits to 30 percent. Therefore, the revised proposed rule maintains a limit of 15 percent of capital for investments in corporate CUSOs, increases the aggregate limit for loans and

investments to 30 percent of capital, and retains the additional 15 percent for loans that are fully secured.

Six commenters requested that the current audit requirements in § 704.11(d)(3) be modified to permit a consolidated CPA audit for wholly owned CUSOs. This modification would mirror the practice that is currently permissible for natural person CUSOs. 63 Fed. Reg. 10743, 10747 (March 5, 1998). The Board agrees but does not believe it is necessary to state it in the regulations since this is a requirement under GAAP for wholly owned CUSOs.

Six commenters supported revising § 704.11(b) so that it mirrors § 712.6 of the natural person CUSO rule. Section 704.11(b) prohibits a corporate from acquiring control directly or indirectly of another "financial institution" and § 712.6 prohibits a natural person credit union from acquiring control directly or indirectly of another "depository financial institution." The Board agrees and has placed the modifier "depository" before "financial institution."

The commenters generally supported clarifying in the CUSO rule that the aggregate limit of § 723.16, the member business loan rule applies to loans to CUSOs. The commenters objected to the other provisions of part 723 applying to those loans and cited a Guidance letter issued by the OCCU as support for their position. The intent of the proposal, as well as the revised proposal, is not to have any additional requirements in part 723 apply except those listed as due diligence requirements.

Permissible Services, Section 704.12

The Board proposed listing six broad categories of permissible financial services for corporate credit unions. They are: Credit and investment services; liquidity and asset liability management; payment systems; electronic financial services; sale or lease of excess physical or information system capacity; and operational services associated with administering or providing financial products or services. Currently, permissible services are not defined but are limited in the preamble to the final rule to "traditional loan, deposit and payment services." 61 FR 28085, 28096 (June 4, 1996).

Twenty of the 21 commenters that commented on this provision objected to the proposed list of services. Some of the reasons given in opposition were that: services should be the same as those listed in part 721; a corporate should be able to seek approval for additional services, as in parts 712 and 721; the services should be listed as broad categories; limiting services to

those currently offered by corporates inhibits the possibility of future development and could force credit unions to go to competitor banks for services; and securities safekeeping, custodial and brokerage services should be added to the list of permissible services. Several commenters objected to changing the name from "services" to "permissible services." One commenter objected to limiting services of federally-insured, state-chartered credit unions (FISCUs). The commenter noted that prior to 1998, this provision did not apply to FISCUs.

The commenter that supported this provision commended NCUA for interpreting permissible services more broadly than the current interpretation. The commenter suggested listing the services as an appendix to the rule.

The Board believes some commenters may have been confused even though the proposal specifically stated that the services listed were broad categories. To eliminate confusion, the Board is listing the permissible services in categories in the same manner they are listed in parts 712 and 721. In addition, like parts 712 and 721, examples of the service are set out under each category. The Board does not agree that the permissible services for a corporate credit union should be the same as for a natural person credit union. The mission of a corporate credit union is serving its natural person credit union members, whereas, the mission of a natural person credit union is serving natural persons. These two distinct missions lead to very different services for members. The Board is retaining the six broad categories in the proposed, adding the category of trustee or custodial services, and including examples under each category. The Board notes that trustee services are limited to those permitted in part 724. Custodial services include acting as custodian or safekeeper of securities or other investments for your members. When performing these services, you must comply with applicable laws, including securities laws.

At the commenters' suggestion, the Board is adding a provision similar to the provisions in parts 712 and 721 concerning adding new permissible services. The new section permits corporates to petition the Board to add a new service to § 704.12 and encourages them to seek an advisory opinion from the Office of General Counsel (OGC) on whether a proposed service is already covered by one of the authorized categories before filing a petition. The rule does not require a corporate to come to OGC for an opinion every time it wants to provide a service

not specifically listed as an example under a broad category. An opinion from OGC is recommended if there is doubt as to whether a specific service falls within one of the broad categories. In those situations, a corporate that does not consult with OGC runs the risk of engaging in an impermissible activity and being subject to supervisory action.

The proposal deleted the requirement that services to nonmember natural person credit unions through a correspondent services agreements could only be provided to those natural person credit unions' branch offices in the corporate's geographic field of membership. In addition, the proposal clarified that a correspondent services agreement is an agreement between two corporates for one of the corporates to provide services to the members of the other. Eleven of the 13 commenters that commented on this issue objected to the clarification.

The negative commenters stated that the requirement: Ignores the reality that a credit union can join almost any corporate; is an antitrust violation and is in restraint of trade; Ignores the existing practice; creates a competitive edge for noncredit union competitors; and will hinder the process of establishing relationships that will lead to membership. Several commenters noted that, with national fields of membership, any credit union can join a corporate and NCUA needs to define member.

The two commenters that supported this provision noted that corporates are still financial cooperatives formed to benefit members and that a national field of membership does not change that basic principle.

The Board agrees with the two positive commenters that corporates, like natural person credit unions, are formed to serve their members. Natural person credit unions are permitted as part of correspondent services to provide services to other natural person credit unions, but are only permitted to serve nonmember natural persons through an agreement with the nonmember's natural person credit union. 12 CFR 721.3(b). The revised proposed rule for corporates, like that for natural person credit unions, requires an agreement between two corporates for one corporate to provide services to the members of the other. In addition, although not in the initial proposal, the revised proposal permits corporates to provide services to other nonmember corporates through a correspondent services agreement, just as natural person credit unions are permitted to provide services to other natural person credit unions through an

agreement. Finally, correspondent services are now listed under permissible services.

The proposal also moved the current prohibition on the purchase of "mortgage servicing rights" from the investment section to this section and renames it "loan servicing rights." Three commenters objected to this current prohibition stating that it is arbitrary and contrary to the concept of business aggregation. The Board is not persuaded by these three commenters based on its safety and soundness concerns with corporates engaging in this type of activity. The Board will maintain the current prohibition in the revised proposed rule.

Fixed Assets, Section 704.13

The proposal eliminated the existing regulatory limit on fixed assets of 15 percent of capital. The proposal noted the monitoring of fixed assets is best accomplished through ongoing supervision rather than through regulation.

The few commenters that commented on this change supported the elimination. Therefore, the revised proposal reflects this change.

Representation, Section 704.14

The proposal clarified that the term "credit union trade association" in § 704.14(a) includes the term affiliates by adding to the regulation the definition of "credit union trade association" in the preamble to the prior final rule. 59 Fed. Reg. 59357, 59358, November 17, 1994. Thirteen of the 14 commenters that commented on this clarification objected to adding a definition of "credit union trade association." The commenters erroneously perceived this as a change, stated that it unnecessarily limits the pool of qualified applicants, and it is not needed in light of the recusal provisions in § 704.14(d). The one positive commenter supported the change because it clarifies the use of the terms "affiliates" and "trade association."

The Board continues to believe that the chairman of the board of a corporate should not serve simultaneously as an officer, director or chair of a national credit union trade association or its affiliates. As the Board stated when this provision was originally drafted, "the chair should be an individual whose loyalty is in no way divided between the corporate credit union and a trade association." 59 FR 59357, 59358, November 17, 1994. (Emphasis added). If the Board were to exclude affiliates from the definition, the chair's loyalty could be divided between the corporate

and the credit union trade association affiliate. Therefore, the revised proposal retains the definition of "credit union trade association" in the initial proposal.

The proposal amends the requirement in § 704.14(a) that both federal and state-chartered corporates comply with federal corporate bylaws governing election procedures to require all corporates comply with § 704.14(a) governing election procedures. All four commenters that commented on this amendment agreed with the proposed change. The Board is retaining these changes in the revised proposal.

Wholesale Corporate Credit Unions, Section 704.19

The proposed rule eliminated separate wholesale corporate rules for minimum capital ratio, minimum NEV ratio, and maximum NEV volatility. In addition, it eliminated reserve transfer and annual validation of the asset and liability management modeling system requirements. A new provision was added that decreased the minimum RUDE ratio requirement for a wholesale corporate to 1 percent, as opposed to the 2 percent requirement for other corporates.

Four commenters addressed capital. None of the commenters addressed the minimum capital ratio, but all four opposed establishing a 1 percent minimum RUDE ratio requirement citing the same reasons they opposed the 2 percent minimum RUDE ratio for other corporates. Two commenters recommended adopting a credit-risk weighted capital approach for a wholesale corporate. Both commenters stated a credit-risk weighted capital system is a more appropriate measurement of capital adequacy than a RUDE ratio.

As discussed in the section addressing capital, the Board is persuaded to eliminate a minimum RUDE ratio requirement but remains convinced retained earnings are a critical component of capital. Therefore, the Board is establishing an earnings retention requirement when the retained earnings ratio is below 1 percent. The Board believes implementing an earnings retention requirement, in lieu of a minimum RUDE ratio requirement, addresses both the need to maintain an appropriate level of retained earnings and eliminates concerns expressed about restricting a wholesale corporate credit union's ability to accept deposits. Recognizing the unique position of a wholesale corporate credit union in the two-tier corporate system, the Board is establishing a 1 percent, rather than a 2 percent, retained earnings ratio

threshold before the earnings retention requirement is in effect. For reasons previously cited, the Board remains unconvinced that a credit-risk weighted capital system for corporate credit unions is a preferred method for determining capital adequacy.

Several comments were received regarding eliminating § 704.19(c)(1). This section addressed separate rules for minimum NEV ratio and maximum NEV volatility. Several commenters objected to eliminating this provision citing a wholesale corporate's need for greater flexibility in managing liquidity. One commenter supported the proposed rule stating there is no basis for maintaining different regulatory requirement for a wholesale corporate. The Board continues to believe exposures associated with interest rate risk are the same regardless of the type of corporate. Therefore, the Board has eliminated this section in the revised proposal.

Two commenters supported the proposed elimination of § 704.19(c)(2) that requires a wholesale corporate to obtain an annual third-party review of its asset and liability management modeling system. This section is eliminated in the revised proposed rule.

Appendix A to Part 704—Model Forms

The proposal added language to the model forms to clarify the treatment of MC and PIC in the event of the merger, liquidation, or charter conversion of a member credit union or the corporate credit union. The proposal also noted that the model forms only set forth the minimum disclosure requirements and that there may be additional disclosures required that the Board has not considered. The Board proposed eliminating the wording that states corporates using the model forms are in compliance with all disclosure requirements.

One commenter indicated full support for all the proposed changes in this section. Several commenters suggested a revision to allow either the corporate's chair or the CEO to sign the annual disclosure. Eight commenters objected only to the removal of the wording that indicates a corporate using the model forms will be in compliance with the disclosure requirements. They suggested the value of providing model forms is to assist the industry in complying with regulatory requirements and expressed concern with having compliance with the terms and conditions of MC and PIC accounts left to an examiner's discretion.

The Board wants each corporate to have the ability to utilize MC and PIC to achieve the best results for its institution and its members. As such, a

corporate's officials may develop features in their MC or PIC offerings that the Board did not consider in adopting the model forms. The Board wants corporates to have the freedom to develop unique MC and PIC accounts, while ensuring member credit unions receive appropriate disclosure on these accounts. Therefore, in the revised proposed regulation, the Board has eliminated the wording that states corporate credit unions using the model forms are in compliance with all disclosure requirements.

The revised proposal also places the signature requirements for the disclosures that are currently only found in the disclosures in the regulation in § 704.3(b)(2) and (c)(1).

Appendix B to Part 704—Expanded Authorities and Requirements

Appendix B provides corporates with incrementally greater authorities provided additional infrastructure and capital requirements are met. The proposed rule introduced a more flexible approach to expanded authorities. The Board proposed changes to this section to: incorporate base plus expanded authorities under this appendix; expand permissible credit ratings on investments; permit corporates that precommit to a higher level of capital the option of a higher level of interest rate risk; ease the requirements for corporates to participate in risk reducing derivative activities; and permit corporates to participate in loan participations with natural person credit unions.

In addition, the proposed rule included minimum standards for any corporate credit union participating in expanded authorities. The minimum standards included requirements for monthly NEV modeling and annual updating of a corporate's self-assessment. No commenters objected to the NEV modeling requirement; however, twelve commenters opposed the establishment of a requirement to update the self-assessment plan originally submitted in a request for expanded authority. The Board is persuaded that updating the self-assessment would be overly burdensome. Therefore, the Board has deleted that requirement from the revised proposed rule.

The Board proposed allowing corporates to select the level of NEV volatility they choose given their level of capital. Recognizing that all corporates do not operate at or seek the same levels of risk, the Board proposed to reduce mandatory capital levels if NEV volatility is maintained at lower levels and to increase it as volatility increases. The Board believed this menu-driven approach would reduce burden on corporate credit unions, allowing them to better manage their risk taking activities in coordination with capital levels. No commenters opposed the approach; however, several commenters opposed the limits established in the proposed rule.

In the proposed rule, the Board limited volatility for a base plus corporate to a maximum of 15 percent.

For Part I, the Board proposed to limit volatility to a maximum of 15 and 20 percent when the corporate credit union had committed to a minimum capital requirement of four and five percent, respectively. For Part II the board proposed to limit volatility to 15, 20, and 30 percent when a corporate credit union had committed to a minimum capital requirement of four, five, or six percent, respectively. Several commenters objected to these volatility levels recommending that volatility levels remain at existing levels. One commenter recommended lowering the volatility levels even further.

After reviewing the comments, the Board is persuaded to increase the proposed volatility levels as noted in Table 1. The Board is establishing NEV decline limits for a base-plus corporate credit union of 20 percent, as illustrated in Table 1. The Board is adopting the menu-driven approach proposed for only Part II expanded authority for corporates requesting both Part I and Part II expanded authorities. The NEV limits in Table 1 reflect reasonable levels of volatility given the infrastructure requirements imposed by this rule. A corporate can obtain greater levels of NEV volatility with Part I authority without incurring the infrastructure costs associated with the ability to assume the additional credit risk permitted in Part II. This flexibility is being provided to enable corporates to manage their balance sheets better.

TABLE 1.—NEV DECLINE LIMITS
[in percent]

Level of expanded authorities	Minimum capital requirement	Proposed rule NEV decline limit	Revised proposed rule NEV decline limit
Base plus	4	15	20
Part I	4	15	20
	5	20	28
	6	(¹)	35
Part II	4	15	20
	5	20	28
	6	30	35

¹ Not proposed.

The Board's estimates of the effect of the NEV decline limits on corporates with expanded authorities are summarized in Table 2. Although the estimated permitted NEV declines are smaller for some corporates with expanded authorities, no corporates reported NEV declines under adverse rate shocks will violate the new NEV decline limits.

TABLE 2.—ESTIMATES OF PERMITTED DECLINES IN NEV FOR BASE-PLUS, PART I, AND PART II CORPORATE CREDIT UNIONS SIMPLE AVERAGES FOR THE QUARTERS ENDING JUNE 2000 THROUGH MARCH 2001

	NEV ratio	NEV decline limit	Permitted decline as % of FV of assets
Base plus			
Current Rule	4.33	25	1.06
Proposed Rule	9.24	20	1.85
Part I			
Current Rule	3.62	35	1.27
Proposed Rule 20	8.44	20	1.69
Proposed Rule 28	8.44	28	2.36
Proposed Rule 35	8.44	35	2.95
Part II			
Current Rule	3.53	50	1.76
Proposed Rule 20	6.51	20	1.30
Proposed Rule 28	6.51	28	1.82
Proposed Rule 35	6.51	35	2.28

The Board will permit any corporate currently approved for Part I or Part II Expanded Authorities to request to lower its NEV decline limit in conjunction with a request to lower its minimum capital requirement from 5 or 6 percent, respectively.

As discussed in § 704.8, asset and liability management, the Board proposed to establish limits for the aggregate credit exposure to a single obligor at 50 percent of capital. This limit provides corporates with substantial flexibility in comparison to other depository institutions. The Board believes this limit is the most credit exposure a corporate credit union should prudently take in investment quality investments. This 50 percent limit will apply to all corporates.

The Board proposed expanding the exception from the general credit concentration rule for repurchase and securities lending transactions for corporate credit unions with Part I or II authority. Due to the increased infrastructure requirements for Part I and II, the Board proposed to establish a 300 percent limit for Part I, and 400 percent limit for Part II. Several commenters objected to the limits stating that the lower levels will significantly reduce their existing limits. The Board believes the proposed levels of risk are appropriate because of the increased requirements for credit analysis for Part I and II corporates; however, the Board believes increasing the limits beyond those proposed would not be prudent.

Part I

Currently, corporates with Part I authority can purchase long-term investments rated no lower than AA-. The Board proposed lowering the minimum rating requirement for a long-

term investment (including asset-backed securities) to A-. One commenter objected to the lowering of the credit standards, since it believes that corporates should only invest in the highest rated instruments. The Board believes these proposed levels of risk are appropriate because of the credit risk analysis infrastructure requirements for Part I and has retained them in the revised proposed rule.

Currently, corporates cannot purchase a short-term investment rated lower than A-1. For Part I corporates, the Board proposed lowering the minimum rating requirement for a short-term investment (including asset-backed securities) to A-2, provided the issuer had a long-term rating no lower than A-. Again, one commenter objected to the lowering of the credit standards, since it believes that corporates should only invest in the highest rated instruments. As stated above, the Board believes these proposed levels of risk are appropriate because of the credit risk analysis infrastructure requirements for Part I and has adopted them in the revised proposed rule. The revised proposed rule clarifies that an asset-backed security with a short-term rating of A-2 is permissible.

The Board proposed to delete authority for Part I corporates to enter into a repurchase transaction where the collateral securities are rated no lower than A (or equivalent). This authority is no longer necessary because the revised proposed rule permits Part I corporates to purchase long-term investments rated no lower than A- (or equivalent). No comments we received on this change and the Board has adopted it in the revised proposed rule.

The current rule generally prohibits when-issued trading, but allows corporates with Part I and II authorities

to engage in when-issued trading when accounted for on a trade date basis. The revised proposed § 704.5(h) would permit all corporates, including those with expanded authorities, to engage in when-issued trading when accounted for on a trade date basis. The reference to when-issued trading in Parts I and II is no longer necessary and is deleted in the revised proposal.

In both Part I and II, the Board proposed clarifying that the aggregate loan limits apply to both revocable and irrevocable lines of credit. Currently, the rule only states "irrevocable lines of credit." The Board deleted the modifier "irrevocable" to clarify this. No comments were received on this proposed change and it is adopted in the revised proposed rule.

Part II

Currently, corporates with Part II authority can purchase long-term investments rated no lower than A- (or equivalent). The Board proposed lowering the minimum rating requirement for a long-term investment (including asset-backed securities) to BBB (flat). Several positive comments were received on this change. One commenter believed even lower rated instruments should be permitted. Given the additional credit risk analysis infrastructure requirements of a Part II corporate, the Board believes the proposed rating is appropriate and has adopted it in the revised proposed rule.

Currently, corporates cannot purchase a short-term investment rated lower than A-1 (or equivalent). For Part II corporates, the Board proposed lowering the minimum rating requirement for a short-term investment (including asset-backed securities) to A-2 (or equivalent), provided the issuer has a long-term rating no lower than BBB

(flat). One commenter believed even lower rated instruments should be permitted. Given the additional credit risk analysis infrastructure requirements of a Part II corporate, the Board believes the proposed rating is appropriate and has adopted it in the revised proposed rule. The revised proposed rule clarifies that an asset-backed security with a short-term rating of A-2 is permissible.

Currently, corporates with Part II authority must establish limits for secured and unsecured loans as a percentage of the corporate's capital plus pledged shares. The Board proposed to limit unsecured loans to 100 percent of capital. This proposed unsecured loan limit is the same as that for a Part I corporate. One commenter noted that corporates operating at this level of expanded authority are capable of making a credit decision and establishing limits utilizing their own expertise. The Board does not believe it is appropriate for any corporate to risk more than 100 percent of its capital to any one member credit union on an unsecured basis. The Board has adopted the proposed limit in the revised proposed rule.

Part III

Corporates with Part III authority may purchase certain foreign investments. The current rule requires the foreign country to be rated no lower than AA (or equivalent) for political and economic stability. The Board proposed to replace this requirement with a requirement for a long-term foreign currency (non-local currency) debt rating no lower than AA- (or equivalent). No negative comments were received so the Board has adopted this change in the revised proposed rule.

The Board proposed to relax the bank issuer or guarantor rating from AA (or equivalent) to AA- (equivalent). This change represented only a minor increase in risk, and provided Part III corporates with additional investment alternatives. Five commenters noted that corporates should be allowed to take credit risk on foreign investments at the same level as permitted for domestic issuers. The Board was persuaded that a credit rating by an NRSRO is consistent between foreign and domestic issuers, so the revised proposed rule is modified to allow corporates the same credit rating levels for foreign and domestic issuers at their level of authority. In addition, several commenters noted that the rule favored banks over other foreign counterparties. The Board agrees this wording favored foreign banks and has modified the revised proposed rule to allow foreign counterparties, not just banks.

The current rule limits non-secured obligations of any single foreign issuer to 150 percent of RUDE and PIC. The Board proposed to limit all obligations of any single foreign issuer or guarantor to 50 percent of capital. The Board believes the limits for foreign issuers or guarantors should be parallel to those of domestic obligors and based on capital rather than RUDE and PIC. The current rule limits non-secured obligations of any single foreign country to 500 percent of RUDE and PIC. The Board proposed to limit all obligations of any single foreign country to 250 percent of capital. This change equates the existing limit based on RUDE and PIC to a limit using the new definition of capital. The Board noted that sovereign risk is present in foreign debt obligation, whether secured or unsecured. No negative comments were received on these changes, and the Board is adopting them in the revised proposed rule.

Part IV

Part IV expanded authorities have been restructured to provide more flexibility among corporates seeking to use derivatives to reduce risk.

The current rule requires corporates to have either Part I or II expanded authorities to qualify for Part IV. The proposal removed this requirement. The Board believes that all corporates demonstrating and possessing the resources, knowledge, systems, and procedures necessary to measure, monitor, and control the risks associated with derivative transactions should be permitted to use these powers. As with all expanded authorities, the corporate in its application must detail the specific types of derivatives they may utilize. The Board believes that derivative transactions, used properly, reduce risk to the institution and its members.

The current rule provides that a corporate may use such derivatives only for creating structured instruments and hedging its own balance sheet and the balance sheet of its members. The proposed rule delineated between the various permissible activities and clarified the Board's original intent, as it relates to hedging "its own balance sheet and the balance sheet of its members." The Board believes corporates should be allowed to manage their own balance sheets, which may at times add risk. The Board's intent as it relates to "its members" is that the activities only be related to risk reduction. An example of this is to reduce a member's exposure to fixed rate mortgage loans by swapping a fixed rate for a floating rate. The Board is

adopting this provision as proposed in the revised proposed rule.

The current rule is silent as to counterparty ratings for derivative transactions with foreign and domestic counterparties. The Board proposed to clarify its intent by adding language in Part IV making the rating requirements parallel with the corporates other permissible activities. Several commenters noted that requiring the counterparty to be rated unintentionally limited a corporate's ability to enter into transactions with government sponsored enterprises, member credit unions, and special purpose entities fully guaranteed by an entity with a minimum rating for comparable term permissible investments. Based on these comments, the Board is adding clarifying language to the revised proposed rule excluding those specific entities from the Part IV rating requirements.

Part V

As discussed in the lending section, new Part V gives corporates the authority to enter into loan participations with their member credit unions. Several commenters objected to the proposed individual and aggregate participation loan limits of 25 and 100 percent of capital, respectively. These commenters recommended the Board establish individual and aggregate participation loan limits on a case-by-case basis. The Board believes safety and soundness factors require retention of the 25 percent individual member credit union limit. A greater concentration of capital for an individual member credit union, particularly, for non-recourse participation loans, could jeopardize the future viability of a corporate because recovery on those loans is limited to the natural person borrower.

The Board agrees with the commenters on the issue of establishing aggregate participation loan limits on a case-by-case basis. The revised proposed rule permits this; however, the Board only intends to permit aggregate participation loan limits above 100 percent of capital after a corporate demonstrates its ability to manage this activity soundly. Once a corporate has demonstrated its ability to soundly manage this activity, the OCCU Director may authorize greater aggregate participation loan limits.

Delegations of Authority

Although not in the initial proposed rule, the Board, in an effort to streamline the regulatory approval process, has delegated to the OCCU Director in the revised proposal, the authority to act on its behalf in

§§ 704.3(e), (g) and (i); 704.8(e); 704.10; 704.15; and 704.19(b).

Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis to describe any significant economic impact any proposed regulation may have on a substantial number of small entities (those under \$1 million in assets). The rule only applies to corporates, all of which have assets well in excess of \$1 million. The proposed amendments will not have a significant economic impact on a substantial number of small credit unions and, therefore, a regulatory flexibility analysis is not required.

Paperwork Reduction Act

NCUA has determined that the proposed regulation does not increase paperwork requirements under the Paperwork Reduction Act of 1995 and regulations of the Office of Management and Budget (OMB). NCUA currently has OMB clearance for part 704's collection requirements (OMB No. 3133-0129).

Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. In adherence to fundamental federalism principles, NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order. The executive order states that: "National action limiting the policymaking discretion of the states shall be taken only where there is constitutional and statutory authority for the action and the national activity is appropriate in light of the presence of a problem of national significance." The risk of loss to federally-insured credit unions and the NCUSIF caused by actions of corporates are concerns of national scope. The proposed rule, if adopted, will help assure that proper safeguards are in place to ensure the safety and soundness of corporates.

The proposed rule, if adopted, applies to all corporates that accept funds from federally-insured credit unions. NCUA believes that the protection of such credit unions, and ultimately the NCUSIF, warrants application of the proposed rule to all corporates, including nonfederally insured. The proposed rule does not impose additional costs or burdens on the states or affect the states' ability to discharge traditional state government functions. NCUA has determined that this proposal may have an occasional direct

effect on the states, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. However, the potential risk to the NCUSIF without the proposed changes justifies them.

The Treasury and General Government Appropriations Act, 1999—Assessment of Federal Regulations and Policies on Families

The NCUA has determined that this proposed rule will not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, 1999, Pub. L. 105-277, 112 Stat. 2681 (1998).

Agency Regulatory Goal

NCUA's goal is to promulgate clear and understandable regulations that impose minimal regulatory burden. We request your comments on whether the proposed rule is understandable and minimally intrusive if implemented as proposed.

List of Subjects

12 CFR Part 703

Credit unions, Investments.

12 CFR Part 704

Credit unions, Reporting and record keeping requirements, Surety bonds.

By the National Credit Union Administration Board on June 20, 2002.

Becky Baker,

Secretary of the Board.

Accordingly, NCUA proposes to amend 12 CFR parts 703 and 704 as follows:

PART 703—INVESTMENT AND DEPOSIT ACTIVITIES

1. The authority citation for part 703 will continue to read as follows:

Authority: 12 U.S.C. 1757(7), 1757(8), and 1757(15).

2. Amend § 703.100 paragraph (c) by revising the second and third sentences and adding a fourth sentence to read as follows:

§ 703.100 What investments and investment activities are permissible for me?

(c) * * * Your aggregate amount of paid-in capital and membership capital in one corporate credit union is limited to two percent of your assets measured at the time of investment or adjustment. Your aggregate amount of paid-in capital and membership capital in all corporate credit unions is limited to four percent of your assets measured at

the time of investment or adjustment. Paid-in capital and membership capital are defined in part 704 of this chapter.

* * * * *

PART 704—CORPORATE CREDIT UNIONS

3. The authority citation for part 704 will continue to read as follows:

Authority: 12 U.S.C. 1762, 1766(a), 1781, and 1789.

4. Amend § 704.2 as follows:

a. Remove the definition of "commercial mortgage related security", "correspondent services", "expected maturity", "long term investment", "market price", "member paid-in capital", "mortgage servicing", "net interest income", "non member paid-in capital", "non secured obligation", "prepayment model", "real estate mortgage investment conduit (REMIC)", "reserve ratio", "reserves and undivided earnings", "short-term investment", and "trade association";

b. Revise the definitions of "capital", "collateralized mortgage obligation (CMO)", "fair value", "forward settlement", "membership capital", "mortgage related security", "paid-in capital", "regular-way settlement", "repurchase transaction", and "residual interest";

c. Amend the definitions of "asset-backed security" by revising the last sentence, and "net economic value (NEV)" by revising the second and third sentences; and

d. Add new definitions for "core capital", "core capital ratio", "limited liquidity investment", "obligor", "quoted market price", "retained earnings", and "retained earnings ratio".

§ 704.2 Definitions.

* * * * *

Asset-backed security * * * This definition excludes mortgage related securities.

Capital means the sum of a corporate credit union's retained earnings, paid-in capital, and membership capital.

* * * * *

Collateralized mortgage obligation (CMO) means a multi-class mortgage related security.

Core capital means the corporate credit union's retained earnings and paid-in capital.

Core capital ratio means the corporate credit union's core capital divided by its moving daily average net assets.

* * * * *

Fair value means the amount at which an instrument could be exchanged in a current, arms-length transaction

between willing parties, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value. If a quoted market price in an active market is not available, fair value may be estimated using a valuation technique that is reasonable and supportable, a quoted market price in an active market for a similar instrument, or a current appraised value. Examples of valuation techniques include the present value of estimated future cash flows, option-pricing models, and option-adjusted spread models. Valuation techniques should incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility.

Forward settlement of a transaction means settlement on a date later than regular-way settlement.

Limited liquidity investment means an investment without a quoted market price.

Membership capital means funds contributed by members that: are adjustable balance with a minimum withdrawal notice of 3 years or are term certificates with a minimum term of 3 years; are available to cover losses that exceed retained earnings and paid-in capital; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings.

Mortgage related security means a security as defined in section 3(a)(41) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(41)), e.g., a privately-issued security backed by mortgages secured by real estate upon which is located a dwelling, mixed residential and commercial structure, residential manufactured home, or commercial structure that is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization.

Net economic value (NEV) * * * All fair value calculations must include the value of forward settlements and embedded options. The amortized portion of membership capital and paid-in capital, which do not qualify as capital, are treated as liabilities for purposes of this calculation. * * *

Obligor means the primary party obligated to repay an investment, e.g., the issuer of a security, the taker of a deposit, or the borrower of funds in a federal funds transaction. Obligor does not include an originator of receivables

underlying an asset-backed security, the servicer of such receivables, or an insurer of an investment.

Paid-in capital means accounts or other interests of a corporate credit union that: are perpetual, non-cumulative dividend accounts; are available to cover losses that exceed retained earnings; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings.

Quoted market price means a recent sales price or a price based on current bid and asked quotations.

Regular-way settlement means delivery of a security from a seller to a buyer within the time frame that the securities industry has established for immediate delivery of that type of security. For example, regular-way settlement of a Treasury security includes settlement on the trade date ("cash"), the business day following the trade date ("regular way"), and the second business day following the trade date ("skip day").

Repurchase transaction means a transaction in which a corporate credit union agrees to purchase a security from a counterparty and to resell the same or any identical security to that counterparty at a specified future date and at a specified price.

Residual interest means the remainder cash flows from a CMO or ABS transaction after payments due bondholders and trust administrative expenses have been satisfied.

Retained earnings means the total of the corporate credit union's undivided earnings, reserves, and any other appropriations designated by management or regulatory authorities. For purposes of this regulation, retained earnings does not include the allowance for loan and lease losses account, accumulated unrealized gains and losses on available for sale securities, accumulated FASB adjustments, or other comprehensive income items.

Retained earnings ratio means the corporate credit union's retained earnings divided by its moving daily average net assets.

5. Amend § 704.3 as follows:

- a. Amend paragraph (a) by revising the paragraph heading;
- b. Redesignate paragraphs (d) through (g) as paragraphs (e) through (h) and paragraph (b) as paragraph (d);
- c. Remove paragraph (c);
- d. Add paragraphs (b), (c), and (i); and

e. Revise redesignated paragraphs (e) heading, (e)(1) introductory text, (e)(2) and (e)(3)(iii) and (f).

§ 704.3 Corporate credit union capital.

(a) Capital plan. * * *

(b) *Requirements for membership capital*—(1) *Form*. Membership capital funds may be in the form of a term certificate or an adjusted balance account.

(2) *Disclosure*. The terms and conditions of a membership capital account must be disclosed to the recorded owner of the account at the time the account is opened and at least annually thereafter.

(i) The initial must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board; and

(ii) The annual disclosure notice must be signed by the chair of the corporate credit union. The chair must sign a statement that certifies that the notice has been sent to member credit unions with membership capital accounts. The certification must be maintained in the corporate credit union's files and be available for examiner review.

(3) *Three-year remaining maturity*. When a membership capital account has been placed on notice or has a remaining maturity of less than three years, the amount of the account that can be considered membership capital is reduced by a constant monthly amortization that ensures membership capital is fully amortized one year before the date of maturity or one year before the end of the notice period. The full balance of a membership capital account being amortized, not just the remaining non-amortized portion, is available to absorb losses in excess of the sum of retained earnings and paid-in capital until the funds are released by the corporate credit union at the time of maturity or the conclusion of the notice period.

(4) *Release*. Membership capital may not be released due solely to the merger, charter conversion or liquidation of a member credit union. In the event of a merger, the membership capital transfers to the continuing credit union. In the event of a charter conversion, the membership capital transfers to the new institution. In the event of liquidation, the membership capital may be released to facilitate the payout of shares with the prior written approval of the OCCU Director.

(5) *Sale*. A member may sell its membership capital to a credit union in the corporate credit union's field of membership, subject to the corporate credit union's approval.

(6) *Liquidation.* In the event of liquidation of a corporate credit union, membership capital is payable only after satisfaction of all liabilities of the liquidation estate, including uninsured share obligations to shareholders and the National Credit Union Share Insurance Fund (NCUSIF), but excluding paid-in capital.

(7) *Merger.* In the event of a merger of a corporate credit union, membership capital transfers to the continuing corporate credit union. The minimum three-year notice period for withdrawal of membership capital remains in effect.

(8) *Adjusted balance accounts:* (i) May be adjusted no more frequently than once every six months; and

(ii) Must be adjusted in relation to a measure (e.g., one percent of a member credit union's assets) established and disclosed at the time the account is opened without regard to any minimum withdrawal period. If the measure is other than assets, the corporate credit union must address the measure's permanency characteristics in its capital plan.

(iii) *Notice of withdrawal.* Upon written notice of intent to withdraw membership capital, the balance of the account will be frozen (no further adjustments) until the conclusion of the notice period.

(9) *Grandfathering.* Membership capital issued before the effective date of this regulation is exempt from the limitation of § 704.3(b)(8)(i).

(c) *Requirements for paid-in capital—*

(1) *Disclosure.* The terms and conditions of any paid-in capital instrument must be disclosed to the recorded owner of the instrument at the time the instrument is created and must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board.

(2) *Release.* Paid-in capital may not be released due solely to the merger, charter conversion or liquidation of a member credit union. In the event of a merger, the paid-in capital transfers to the continuing credit union. In the event of a charter conversion, the paid-in capital transfers to the new institution. In the event of liquidation, the paid-in capital may be released to facilitate the payout of shares with the prior written approval of the OCCU Director.

(3) *Callability.* Paid-in capital accounts are callable on a pro-rata basis across an issuance class only at the option of the corporate credit union and only if the corporate credit union meets its minimum level of required capital and NEV ratios after the funds are called.

(4) *Liquidation.* In the event of liquidation of the corporate credit union, paid-in capital is payable only after satisfaction of all liabilities of the liquidation estate, including uninsured share obligations to shareholders, the NCUSIF, and membership capital holders.

(5) *Merger.* In the event of a merger of a corporate credit union, paid-in capital shall transfer to the continuing corporate credit union.

(6) Paid-in capital includes both member and nonmember paid-in capital.

(i) Member paid-in capital means paid-in capital that is held by the corporate credit union's members. A corporate credit union may not condition membership, services, or prices for services on a credit union's ownership of paid-in capital.

(ii) Nonmember paid-in capital means paid-in capital that is not held by the corporate credit union's members.

(7) *Grandfathering.* A corporate credit union's authority to include paid-in capital as a component of capital is governed by the regulation in effect at the time the paid-in capital was issued. When a grandfathered paid-in capital instrument has a remaining maturity of less than 3 years, the amount that may be considered paid-in capital is reduced by a constant monthly amortization that ensures the paid-in capital is fully amortized 1 year before the date of maturity. The full balance of grandfathered paid-in capital being amortized, not just the remaining non-amortized portion, is available to absorb losses in excess of retained earnings until the funds are released by the corporate credit union at maturity.

* * * * *

(e) *Individual capital ratio requirement—*(1) When significant circumstances or events warrant, the OCCU Director may require a different minimum capital ratio for an individual corporate credit union based on its circumstances. Factors that may warrant a different minimum capital ratio include, but are not limited to, for example:

* * * * *

(2) When the OCCU Director determines that a different minimum capital ratio is necessary or appropriate for a particular corporate credit union, he or she will notify the corporate credit union in writing of the proposed capital ratio and, if applicable, the date by which the capital ratio should be reached. The OCCU Director also will provide an explanation of why the proposed capital ratio is considered

necessary or appropriate for the corporate credit union.

(3) * * *

(iii) After the close of the corporate credit union's response period, the OCCU Director will decide, based on a review of the corporate credit union's response and other information concerning the corporate credit union, whether a different minimum capital ratio should be established for the corporate credit union and, if so, the capital ratio and the date the requirement will become effective. The corporate credit union will be notified of the decision in writing. The notice will include an explanation of the decision, except for a decision not to establish a different minimum capital ratio for the corporate credit union.

(f) *Failure to maintain minimum capital ratio requirement.* When a corporate credit union's capital ratio falls below the minimum required by paragraphs (d) or (e) of this section, or appendix B to this part, as applicable, operating management of the corporate credit union must notify its board of directors, supervisory committee, and the OCCU Director within 10 calendar days.

* * * * *

(i) *Earnings retention requirement.* A corporate credit union must increase retained earnings if the prior month-end retained earnings ratio is less than 2 percent.

(1) Its retained earnings must increase:

(i) During the current month, by an amount equal to or greater than the monthly earnings retention amount; or

(ii) During the current and prior two months, by an amount equal to or greater than the quarterly earnings retention amount.

(2) Earnings retention amounts are calculated as follows:

(i) The monthly earnings retention amount is determined by multiplying the earnings retention factor by the prior month-end moving daily average net assets; and

(ii) The quarterly earnings retention amount is determined by multiplying the earnings retention factor by moving daily average net assets for each of the prior three month-ends.

(3) The earnings retention factor is determined as follows:

(i) If the prior month-end retained earnings ratio is less than 2 percent and the core capital ratio is less than 3 percent, the earnings retention factor is .15 percent per annum; or

(ii) If the prior month-end retained earnings ratio is less than 2 percent and the core capital ratio is equal to or

greater than 3 percent, the earnings retention factor is .10 percent per annum.

(4) The OCCU Director may approve a decrease to the earnings retention amount if it is determined a lesser amount is necessary to avoid a significant adverse impact upon a corporate credit union.

(5) A corporate credit union may authorize the payment of dividends provided:

(i) The payment will not cause the retained earnings ratio to fall below 2 percent;

(ii) The payment will not cause the amount of retained earnings to decrease from the prior month-end, unless the decrease results from losses on the sale of investments; or

(iii) The OCCU Director and, if applicable, state regulator have given prior written approval for the payment.

6. Amend § 704.4 by removing the word "operating" wherever it appears in paragraphs (a) and (b) and revising paragraph (c) introductory text to read as follows:

§ 704.4 Board responsibilities.

* * * * *

(c) *Other requirements.* The board of directors of a corporate credit union must ensure:

* * * * *

7. Amend § 704.5 as follows:

a. Revise paragraphs (a)(1) and (2), (c)(5), (d)(1), (e)(1), (3) and (4), (f), and (h)(2) and (3);

b. Remove paragraphs (c)(6), (d)(3) and (d)(6);

c. Redesignate paragraphs (d)(4) and (d)(5) as paragraphs (d)(3) and (d)(4);

d. Revise redesignated paragraphs (d)(3) and the first sentence of (d)(4);

e. Add paragraph (h)(4); and

f. Add at the end of paragraph (c)(4) after the ";" an "and."

§ 704.5 Investments.

(a) * * *

(1) Appropriate tests and criteria for evaluating investments and investment transactions prior to purchase; and

(2) Reasonable and supportable concentration limits for limited liquidity investments in relation to capital.

* * * * *

(c) * * *

(5) Domestically-issued asset-backed securities.

(d) * * *

(1) The corporate credit union, directly or through its agent, receives written confirmation of the transaction, and either takes physical possession or control of the repurchase securities or is recorded as owner of the repurchase

securities through the Federal Reserve Book-Entry Securities Transfer System;

* * * * *

(3) The corporate credit union, directly or through its agent, receives daily assessment of the market value of the repurchase securities and maintains adequate margin that reflects a risk assessment of the repurchase securities and the term of the transaction; and

(4) The corporate credit union has entered into signed contracts with all approved counterparties and agents, and ensures compliance with the contracts.

* * *

(e) * * *

(1) The corporate credit union, directly or through its agent, receives written confirmation of the loan, obtains a first priority security interest in the collateral by taking physical possession or control of the collateral, or is recorded as owner of the collateral through the Federal Reserve Book-Entry Securities Transfer System;

* * * * *

(3) The corporate credit union, directly or through its agent, receives daily assessment of the market value of collateral and maintains adequate margin that reflects a risk assessment of the collateral and terms of the loan; and

(4) The corporate credit union has entered into signed contracts with all agents and, directly or through its agent, has executed a written loan and security agreement with the borrower. The corporate or its agent ensures compliance with the agreements.

(f) *Investment companies.* A corporate credit union may invest in an investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a), provided that the prospectus of the company restricts the investment portfolio to investments and investment transactions that are permissible for that corporate credit union.

* * * * *

(h) * * *

(2) Engaging in trading securities unless accounted for on a trade date basis;

(3) Engaging in adjusted trading or short sales; and

(4) Purchasing stripped mortgage-backed securities, small business related securities, or residual interests in CMOs or asset-backed securities.

* * * * *

8. Amend § 704.6 by revising paragraphs (a) introductory text and paragraphs (a)(3), (a)(4) and (b) through (e) to read as follows:

§ 704.6 Credit risk management.

(a) Policies. A corporate credit union must operate according to a credit risk management policy that is commensurate with the investment risks and activities it undertakes. The policy must address at a minimum:

* * * * *

(3) Maximum credit limits with each obligor and transaction counterparty, set as a percentage of capital. In addition to addressing deposits and securities, limits with transaction counterparties must address aggregate exposures of all transactions, including, but not necessarily limited to, repurchase agreements, securities lending, and forward settlement of purchases or sales of investments; and

(4) Concentrations of credit risk (e.g., originator of receivables, insurer, industry type, sector type, and geographic).

(b) *Exemption.* The requirements of this section do not apply to investments that are issued or fully guaranteed as to principal and interest by the U.S. government or its agencies or enterprises (excluding subordinated debt) or are fully insured (including accumulated interest) by the National Credit Union Share Insurance Fund or Federal Deposit Insurance Corporation.

(c) *Concentration limits*—(1) *General rule.* The aggregate of all investments in any single obligor is limited to 50 percent of capital or \$5 million, whichever is greater.

(2) *Exceptions.* Exceptions to the general rule are:

(i) Aggregate investments in repurchase and securities lending agreements with any one counterparty are limited to 200 percent of capital;

(ii) Investments in corporate CUSOs are subject to the limitations of § 704.11; and

(iii) Aggregate investments in corporate credit unions are not subject to the limitations of paragraph (c)(1) of this section.

(3) For purposes of measurement, each new credit transaction must be evaluated in terms of the corporate credit union's capital at the time of the transaction. An investment that fails a requirement of this section because of a subsequent reduction in capital will be deemed nonconforming. A corporate credit union is required to exercise reasonable efforts to bring nonconforming investments into conformity within 90 days. Investments that remain nonconforming for 90 days will be deemed to fail a requirement of this section and will require compliance with § 704.10.

(d) *Credit ratings*—(1) All investments, other than in a corporate

credit union or CUSO, must have an applicable credit rating from at least one nationally recognized statistical rating organization (NRSRO).

(2) At the time of purchase, investments with long-term ratings must be rated no lower than AA- (or equivalent) and investments with short-term ratings must be rated no lower than A-1 (or equivalent).

(3) Any rating(s) relied upon to meet the requirements of this part must be identified at the time of purchase and must be monitored for as long as the corporate owns the investment.

(4) When two or more ratings are relied upon to meet the requirements of this part at the time of purchase, the board or an appropriate committee must place on the § 704.6(e)(1) investment watch list any rating that is downgraded below the minimum rating requirements of this part.

(5) Investments are subject to the requirements of § 704.10 if:

(i) One rating was relied upon to meet the requirements of this part and that rating is downgraded below the minimum rating requirements of this part; or

(ii) Two or more ratings were relied upon to meet the requirements of this part and at least two of those ratings are downgraded below the minimum rating requirements of this part.

(e) *Reporting and documentation.* (1) A written evaluation of each credit limit with each obligor or transaction counterparty must be prepared at least annually and formally approved by the board or an appropriate committee. At least monthly, the board or an appropriate committee must receive an investment watch list of existing and/or potential credit problems and summary credit exposure reports, which demonstrate compliance with the corporate credit union's risk management policies.

(2) At a minimum, the corporate credit union must maintain:

(i) A justification for each approved credit limit;

(ii) Disclosure documents, if any, for all instruments held in portfolio. Documents for an instrument that has been sold must be retained until completion of the next NCUA examination; and

(iii) The latest available financial reports, industry analyses, internal and external analyst evaluations, and rating agency information sufficient to support each approved credit limit.

9. Amend § 704.7 by removing paragraphs (c) through (g), adding paragraphs (c) through (f) and redesignating paragraph (h) as paragraph (g) to read as follows:

§ 704.7 Lending.

* * * * *

(c) *Loans to members*—(1) *Credit unions.* (i) The maximum aggregate amount in unsecured loans and lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, must not exceed 50 percent of capital.

(ii) The maximum aggregate amount in secured loans and lines of credit to any one member credit union, excluding those secured by shares or marketable securities and member reverse repurchase transactions, must not exceed 100 percent of capital.

(2) *Corporate CUSOs.* Any loan or line of credit must comply with § 704.11.

(3) *Other members.* The maximum aggregate amount of loans and lines of credit to any other one member must not exceed 15 percent of the corporate credit union's capital plus pledged shares.

(d) *Loans to nonmembers*—(1) Credit unions. A loan to a nonmember credit union, other than through a loan participation with another corporate credit union, is only permissible if the loan is for an overdraft related to the providing of correspondent services pursuant to § 704.12. Generally, such a loan will have a maturity of one business day.

(2) *Corporate CUSOs.* Any loan or line of credit must comply with § 704.11.

(e) *Member business loan rule*—Loans, lines of credit and letters of credit to:

(1) Member credit unions are exempt from part 723 of this chapter;

(2) Corporate CUSOs must comply with § 704.11; and

(3) Other members not excluded under § 723.1(b) of this chapter must comply with part 723 of this chapter unless the loan or line of credit is fully guaranteed by a credit union or fully secured by US Treasury or agency securities. Those guaranteed and secured loans must comply with the aggregate limits of § 723.16 but are exempt from the other requirements of part 723.

(f) *Participation loans with other corporate credit unions.* A corporate credit union is permitted to participate in a loan with another corporate credit union provided the corporate retains an interest of at least 5 percent of the face amount of the loan and a master participation loan agreement is in place before the purchase or the sale of a participation. A participating corporate credit union must exercise the same due diligence as if it were the originating corporate credit union.

* * * * *

10. Amend § 704.8 as follows:

a. Remove paragraphs (a)(2), (a)(5) and (e);

b. Redesignate paragraphs (a)(3) and (a)(4) as (a)(2) and (a)(3), (a)(6) and (a)(7) as (a)(4) and (a)(5), and (f) and (g) as (e) and (f);

c. Add paragraph (a)(6) and “; and” at the end of redesignated paragraph (a)(5) in place of the period;

d. Revise redesignated paragraphs (a)(2), (e) and (f);

e. Add a sentence to the end of the end of paragraph (c); and

f. Revise paragraphs (d)(1)(i) through (iii) and (d)(2) introductory text.

§ 704.8 Asset and liability management.

(a) * * *

(2) The maximum allowable percentage decline in net economic value (NEV), compared to base case NEV;

* * * * *

(6) The tests that will be used, prior to purchase, to estimate the impact of investments on the percentage decline in NEV, compared to base case NEV. The most recent NEV analysis, as determined under paragraph (d)(1)(i) of this section may be used as a basis of estimation.

* * * * *

(c) * * * This means the minimum penalty must be reasonably related to the rate that the corporate credit union would be required to offer to attract funds for a similar term with similar characteristics.

(d) * * *

(1) * * *

(i) Evaluate the risk in its balance sheet by measuring, at least quarterly, the impact of an instantaneous, permanent, and parallel shock in the yield curve of plus and minus 100, 200, and 300 basis points on its NEV and NEV ratio. If the base case NEV ratio falls below 3 percent at the last testing date, these tests must be calculated at least monthly until the base case NEV ratio again exceeds 3 percent;

(ii) Limit its risk exposure to levels that do not result in a base case NEV ratio or any NEV ratio resulting from the tests set forth in paragraph (d)(1)(i) of this section below 2 percent; and

(iii) Limit its risk exposures to levels that do not result in a decline in NEV of more than 15 percent.

(2) A corporate credit union must assess annually if it should conduct periodic additional tests to address market factors that may materially impact that corporate credit union's NEV. These factors should include, but are not limited to, the following:

* * * * *

(e) *Regulatory violations.* If a corporate credit union's decline in NEV, base case NEV ratio or any NEV ratio resulting from the tests set forth in paragraph (d)(1)(i) of this section violates the limits established by this rule and is not brought into compliance within 10 calendar days, operating management of the corporate credit union must immediately report the information to the board of directors, supervisory committee, and the OCCU Director. If any violation persists for 30 calendar days, the corporate credit union must submit a detailed, written action plan to the OCCU Director that sets forth the time needed and means by which it intends to correct the violation. If the OCCU Director determines that the plan is unacceptable, the corporate credit union must immediately restructure the balance sheet to bring the exposures back within compliance or adhere to an alternative course of action determined by the OCCU Director.

(f) *Policy violations.* If a corporate credit union's decline in NEV, base case NEV ratio, or any NEV ratio resulting from the tests set forth in paragraph (d)(1)(i) of this section violates the limits established by its board, it must determine how it will bring the exposure within policy limits. The disclosure to the board of the violation must occur no later than its next regularly scheduled board meeting.

10a. Amend § 704.10 by revising the heading to read as follows:

§ 704.10 Investment action plan.

11. Amend § 704.11 by revising paragraph (b), redesignating paragraphs (c) through (e) as paragraphs (f) through (h) and adding paragraphs (c), (d) and (e) to read as follows:

§ 704.11 Corporate Credit Union Service Organizations (Corporate CUSOs).

* * * * *

(b) *Investment and loan limitations.*

(1) The aggregate of all investments in member and nonmember corporate CUSOs must not exceed 15 percent of a corporate credit union's capital. (2) The aggregate of all investments in and loans to member and nonmember corporate CUSOs must not exceed 30 percent of a corporate credit union's capital. A corporate credit union may lend to member and nonmember corporate CUSOs an additional 15 percent of capital if the loan is collateralized by assets in which the corporate has a perfected security interest under state law.

(3) If the limitations in paragraphs (b)(1) and (b)(2) of this section are reached or exceeded because of the

profitability of the CUSO and the related GAAP valuation of the investment under the equity method without an additional cash outlay by the corporate, divestiture is not required. A corporate credit union may continue to invest up to the regulatory limit without regard to the increase in the GAAP valuation resulting from the corporate CUSO's profitability.

(4) The aggregate of all loans to corporate CUSOs must comply with the aggregate limit of § 723.16 of this chapter. This requirement does not apply to loans excluded under § 723.1(b).

(c) *Due diligence.* A corporate credit union must comply with the due diligence requirements of §§ 723.5 and 723.6(f) through (l) of this chapter for all loans to corporate CUSOs. This requirement does not apply to loans excluded under § 723.1(b).

(d) *Separate entity.* (1) A corporate CUSO must be operated as an entity separate from a corporate credit union.

(2) The corporate credit union investing in or lending to a corporate CUSO must obtain a written legal opinion that the corporate CUSO is organized and operated in a manner that the corporate credit union will not reasonably be held liable for the obligations of the corporate CUSO. This opinion must address factors that have led courts to "pierce the corporate veil" such as inadequate capitalization, lack of corporate identity, common boards of directors and employees, control of one entity over another, and lack of separate books and records.

(e) *Prohibited activities.* A corporate credit union may not use this authority to acquire control, directly or indirectly, of another depository financial institution, or to invest in shares, stocks, or obligations of another depository financial institution, insurance company, trade association, liquidity facility, or similar organization.

* * * * *

12. Revise § 704.12 to read as follows:

§ 704.12 Permissible services.

(a) *Preapproved services.* NCUA may at any time, based upon supervisory, legal, or safety and soundness reasons, limit or prohibit any preapproved service. The specific activities listed within each preapproved category are provided as illustrations of activities permissible under the particular category, not as an exclusive or exhaustive list. A corporate credit union may provide the following services to its members:

(1) *Correspondent services agreement.* A corporate credit union may only provide financial services to

nonmembers through a correspondent services agreement. A correspondent services agreement is an agreement between two corporate credit unions, whereby one of the corporate credit unions agrees to provide services to the other corporate credit union or its members.

(2) *Credit and investment services.*

Credit and investment services are advisory and consulting activities that assist the member in lending or investment management. These services may include loan reviews, investment portfolio reviews and investment advisory services.

(3) *Electronic financial services.*

Electronic financial services are any services, products, functions, or activities that a corporate credit union is otherwise authorized to perform, provide or deliver to its members but performed through electronic means. Electronic services may include automated teller machines, online transaction processing through a website, website hosting services, account aggregation services, and internet access services to perform or deliver products or services to members.

(4) *Excess capacity.* Excess capacity is the excess use or capacity remaining in facilities, equipment or services that: a corporate credit union properly invested in or established, in good faith, with the intent of serving its members; and it reasonably anticipates will be taken up by the future expansion of services to its members. A corporate credit union may sell or lease the excess capacity in facilities, equipment or services, such as office space, employees and data processing.

(5) *Liquidity and asset and liability management.* Liquidity and asset and liability management services are any services, functions or activities that assist the member in liquidity and balance sheet management. These services may include liquidity planning and balance sheet modeling and analysis.

(6) *Operational services.* Operational services are services established to deliver financial products and services that enhance member service and promote safe and sound operations. Operational services may include tax payment, electronic fund transfers and providing coin and currency service.

(7) *Payment systems.* Payment systems are any methods used to facilitate the movement of funds for transactional purposes. Payment systems may include Automated Clearing House, wire transfer, item processing and settlement services.

(8) *Trustee or custodial services.* Trustee services are services in which

the corporate credit union is authorized to act under a written trust agreement to the extent permitted under part 724 of this chapter. Custodial and safekeeping services are services a corporate credit union performs on behalf of its member to act as custodian or safekeeper of investments.

(b) *Procedure for adding services that are not preapproved.* To provide a service to its members that is not preapproved by NCUA, a corporate credit union must request approval from NCUA. The request must include a full explanation and complete documentation of the service and how the service relates to a corporate credit union's authority to provide services to its members. The request must be submitted jointly to the OCCU Director and the Secretary of the Board. The request will be treated as a petition to amend § 704.12 and NCUA will request public comment or otherwise act on the petition within a reasonable period of time. Before engaging in the formal approval process, a corporate credit union should seek an advisory opinion from NCUA's Office of General Counsel as to whether a proposed service is already covered by one of the authorized categories without filing a petition to amend the regulation.

(c) *Prohibition.* A corporate credit union is prohibited from purchasing loan servicing rights.

§ 704.13 [Removed and Reserved]

13. Remove and reserve § 704.13.

14. Amend § 704.14 by revising paragraph (a) introductory text, redesignating paragraphs (b) through (d) as (c) through (e), and adding a new paragraph (b) to read as follows:

§ 704.14 Representation.

(a) *Board representation.* The board will be determined as stipulated in its bylaws governing election procedures, provided that:

* * * * *

(b) *Credit union trade association.* As used in this section, it includes but is not limited to, state credit union leagues and league service corporations, national credit union trade associations and their affiliates and service organizations, and local, state, and national special interest credit union associations and organizations.

* * * * *

15. Amend § 704.19 by revising paragraph (b) and removing paragraph (c) as follows:

§ 704.19 Wholesale corporate credit unions.

* * * * *

(b) *Earnings retention requirement.* A wholesale corporate credit union must increase retained earnings if the prior month-end retained earnings ratio is less than 1 percent.

(1) Its retained earnings must increase:

(i) During the current month, by an amount equal to or greater than the monthly earnings retention amount; or
(ii) During the current and prior two months, by an amount equal to or greater than the quarterly earnings retention amount.

(2) Earnings retention amounts are calculated as follows:

(i) The monthly earnings retention amount is determined by multiplying the earnings retention factor by the prior month-end moving daily average net assets; and

(ii) The quarterly earnings retention amount is determined by multiplying the earnings retention factor by moving daily average net assets for each of the prior three month-ends.

(3) The earnings retention factor is determined as follows:

(i) If the prior month-end retained earnings ratio is less than 1 percent and the core capital ratio is less than 3 percent, the earnings retention factor is .15 percent per annum; or

(ii) If the prior month-end retained earnings ratio is less than 1 percent and the core capital ratio is equal to or greater than 3 percent, the earnings retention factor is .075 percent per annum.

(4) The OCCU Director may approve a decrease to the earnings retention amount set forth in this section if it is determined a lesser amount is necessary to avoid a significant adverse impact upon a wholesale corporate credit union.

(5) A corporate credit union may authorize the payment of dividends provided either:

(i) The payment will not cause the retained earnings ratio to fall below 1 percent;

(ii) The payment will not cause the amount of retained earnings to decrease from the prior month-end, unless the decrease results from losses on the sale of investments; or

(iii) The OCCU Director and, if applicable, state regulator have given prior written approval for the payment.

16. Revise appendix A to part 704 as follows:

Appendix A to Part 704—Model Forms

This appendix contains sample forms intended for use by corporate credit unions to aid in compliance with the membership capital account and paid-in capital disclosure requirements of § 704.3.

Sample Form 1

Terms and Conditions of Membership Capital Account

(1) A membership capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A membership capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the membership capital account transfers to the continuing credit union. In the event of a charter conversion, the membership capital account transfers to the new institution. In the event of liquidation, the membership capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) A member credit union may withdraw membership capital with three years' notice.

(4) Membership capital cannot be used to pledge borrowings.

(5) Membership capital is available to cover losses that exceed retained earnings and paid-in capital.

(6) Where the corporate credit union is liquidated, membership capital accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF.

(7) Where the corporate credit union is merged into another corporate credit union the membership capital account shall transfer to the continuing corporate credit union. The three-year notice period for withdrawal of the membership capital account will remain in effect.

(8) {If an adjusted balance account}: The membership capital balance will be adjusted ____ (1 or 2) ____ time(s) annually in relation to the member credit union's ____ (assets or other measure) ____ as of ____ (date(s)) ____ . {If a term certificate}: The membership capital account is a term certificate that will mature on ____ (date) ____ .

I have read the above terms and conditions and I understand them. I further agree to maintain in the credit union's files the annual notice of terms and conditions of the membership capital account.

The notice form must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

The annual disclosure notice form must be signed by the chair of the corporate credit union. The chair must then sign a statement that certifies that the notice has been sent to member credit unions with membership capital

accounts. The certification must be maintained in the corporate credit union's files and be available for examiner review.

Sample Form 2

Terms and Conditions of Paid-In Capital

(1) A paid-in capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A paid-in capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the paid-in capital account transfers to the continuing credit union. In the event of a charter conversion, the paid-in capital account transfers to the new institution. In the event of liquidation, the paid-in capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) The funds are callable only at the option of the corporate credit union and only if the corporate credit union meets its minimum required capital and NEV ratios after the funds are called.

(4) Paid-in capital cannot be used to pledge borrowings.

(5) Paid-in capital is available to cover losses that exceed retained earnings.

(6) Where the corporate credit union is liquidated, paid-in capital accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, and membership capital holders.

(7) Where the corporate credit union is merged into another corporate credit union the paid-in capital account shall transfer to the continuing corporate credit union.

(8) Paid-in capital is perpetual maturity and noncumulative dividend.

I have read the above terms and conditions and I understand them. I further agree to maintain in the credit union's files the annual notice of terms and conditions of the paid-in capital instrument.

The notice form must be signed by either all of the directors of the credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

17. Revise appendix B to part 704 as follows:

Appendix B to Part 704—Expanded Authorities and Requirements

A corporate credit union may obtain all or part of the expanded authorities contained in this appendix if it meets all of the requirements of this part 704 and the minimum requirement of this appendix, fulfills additional

management, infrastructure, and asset and liability requirements, and receives NCUA's written approval. The additional requirements are set forth in the NCUA publication Guidelines for Submission of Requests for Expanded Authority.

A corporate credit union seeking expanded authorities must submit to NCUA a self-assessment plan supporting its request. A corporate credit union may adopt expanded authorities when NCUA has provided final approval. If NCUA denies a request for expanded authorities, it will advise the corporate of the reason(s) for the denial and what it must do to resubmit its request. NCUA may revoke these expanded authorities at any time if an analysis indicates a significant deficiency. NCUA will notify the corporate credit union in writing of the identified deficiency. A corporate credit union may request, in writing, reinstatement of the revoked authorities by providing a self-assessment plan detailing how it has corrected the deficiency.

Minimum Requirement

In order to participate in any of the authorities set forth in Base-Plus, Part I, Part II, Part III, Part IV, and Part V of this appendix, a corporate credit union must evaluate monthly the changes in NEV and the NEV ratio for the tests set forth in § 704.8(d)(1)(i).

Base-Plus

A corporate which has met the requirements for this Base-plus authority may, in performing the rate stress tests set forth in § 704.8(d)(1)(i), allow its NEV to decline as much as 20 percent.

Part I

(a) A corporate credit union which has met the requirements for this Part I may:

(1) Purchase investments with long-term ratings no lower than A – (or equivalent);

(2) Purchase investments with short-term ratings no lower than A – 2 (or equivalent), provided that the issuer has a long-term rating no lower than A – (or equivalent) or the investment is a domestically-issued asset-backed security;

(3) Engage in short sales of permissible investments to reduce interest rate risk;

(4) Purchase principal only (PO) stripped mortgage-backed securities to reduce interest rate risk; and

(5) Enter into a dollar roll transaction.

(b) Aggregate investments in repurchase and securities lending

agreements with any one counterparty are limited to 300 percent of capital.

(c) In performing the rate stress tests set forth in § 704.8(d)(1)(i), the NEV of a corporate credit union which has met the requirements of this Part I may decline as much as:

(1) 20 percent;

(2) 28 percent if the corporate credit union has a 5 percent minimum capital ratio and is specifically approved by NCUA; or

(3) 35 percent if the corporate credit union has a 6 percent minimum capital ratio and is specifically approved by NCUA.

(d) The maximum aggregate amount in unsecured loans and lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, shall not exceed 100 percent of the corporate credit union's capital. The board of directors will establish the limit, as a percent of the corporate credit union's capital plus pledged shares, for secured loans and lines of credit.

Part II

(a) A corporate credit union which has met the requirements for this Part II may:

(1) Purchase investments with long-term ratings no lower than BBB (flat) (or equivalent);

(2) Purchase investments with short-term ratings no lower than A–2 (or equivalent), provided that the issuer has a long-term rating no lower than BBB (flat) (or equivalent) or the investment is a domestically issued asset-backed security;

(3) Engage in short sales of permissible investments to reduce interest rate risk;

(4) Purchase principal only (PO) stripped mortgage-backed securities to reduce interest rate risk; and

(5) Enter into a dollar roll transaction.

(b) Aggregate investments in repurchase and securities lending agreements with any one counterparty are limited to 400 percent of capital.

(c) In performing the rate stress tests set forth in § 704.8(d)(1)(i), the NEV of a corporate credit union which has met the requirements of this Part II may decline as much as:

(1) 20 percent;

(2) 28 percent if the corporate credit union has a 5 percent minimum capital ratio and is specifically approved by NCUA; or

(3) 35 percent if the corporate credit union has a 6 percent minimum capital ratio and is specifically approved by NCUA.

(d) The maximum aggregate amount in unsecured loans and lines of credit to

any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, shall not exceed 100 percent of the corporate credit union's capital. The board of directors will establish the limit, as a percent of the corporate credit union's capital plus pledged shares, for secured loans and lines of credit.

Part III

(a) A corporate credit union which has met the requirements of either Part I or Part II of this Appendix and the additional requirements for Part III may invest in:

(1) Debt obligations of a foreign country;

(2) Deposits and debt obligations of foreign banks or obligations guaranteed by these banks;

(3) Marketable debt obligations of foreign corporations. This authority does not apply to debt obligations that are convertible into the stock of the corporation; and

(4) Foreign issued asset-backed securities.

(b) All foreign investments are subject to the following requirements:

(1) Investments must be rated no lower than the minimum permissible domestic rating under the corporate credit union's Part I or Part II authority;

(2) A sovereign issuer, and/or the country in which an obligor is organized, must have a long-term foreign currency (non-local currency)

debt rating no lower than AA-(or equivalent);

(3) For each approved foreign bank line, the corporate credit union must identify the specific banking centers and branches to which it will lend funds;

(4) Obligations of any single foreign obligor may not exceed 50 percent of capital; and

(5) Obligations in any single foreign country may not exceed 250 percent of capital.

Part IV

(a) A corporate credit union which has met the requirements for this Part IV may enter into derivative transactions specifically approved by NCUA to:

(1) Create structured products;

(2) Manage its own balance sheet; and

(3) Hedge the balance sheet of its members.

(b) Credit Ratings:

(1) All derivative transactions are subject to the following requirements:

(i) If the counterparty is domestic, the counterparty rating can be no lower than the minimum permissible rating for comparable term permissible investments; and

(ii) If the counterparty is foreign, the counterparty rating can be no lower than the minimum permissible rating for a comparable term investment under Part III Authority.

(2) Exceptions. Credit ratings are not required for derivative transactions with:

(i) Domestically chartered credit unions;

(ii) U.S. Government sponsored enterprises; or

(iii) Counterparties if the transaction is fully guaranteed by an entity with a minimum permissible rating for comparable term investments.

Part V

A corporate credit union, which has met the requirements for this Part V, may participate in loans with member natural person credit unions as approved by the OCCU Director and subject to the following limitations:

(a) The maximum aggregate amount of participation loans with any one member credit union shall not exceed 25 percent of capital; and

(b) The maximum aggregate amount of participation loans with all member credit unions shall be determined on a case-by-case basis by the OCCU Director.

§§ 704.3, 704.10, 704.15 [Amended]

19. In addition to the amendments set forth above, in 12 CFR part 704 remove the acronym "NCUA" wherever it appears and add in its place, the words "the OCCU Director" in the following places:

a. Redesignated § 704.3(e)(3)(i) and (ii), (g)(2)(v) and (g)(3).

b. Section 704.10(a) introductory text, (b) and (c).

c. Section 704.15(a) and (b).

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